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OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF FEDERAL BANK REGULATION

(Regulation of Problem Banks)

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON GOVERNMENT OPERATIONS HOUSE OF REPRESENTATIVES

NINETY-FOURTH CONGRESS

SECOND SESSION

JANUARY 20; FEBRUARY 3; AND JUNE 16, 1976

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OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF FEDERAL BANK REGULATION

(Regulation of Problem Banks)

TUESDAY, JANUARY 20, 1976

HOUSE OF REPRESENTATIVES,
COMMERCE, CONSUMER,
AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 2154, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Cardiss Collins, Robert F. Drinan, Elliott H. Levitas, Anthony Moffett, Andrew Maguire, Edward Mezvinsky, Garry Brown, and Willis D. Gradison, Jr.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Ronald A. Klempner, counsel; Eleanor M. Vanyo, assistant clerk; and Stephen M. Daniels, minority professional staff, Committee on Government Operations.

OPENING STATEMENT OF CHAIRMAN ROSENTHAL

Mr. ROSENTHAL. The subcommittee will be in order.

Today's hearing by the Commerce, Consumer, and Monetary Affairs Subcommittee is the second of an extended series on the efficiency and adequacy of the Federal bank regulatory system.

Last week the subcommittee reviewed, at a hearing in New York, the examination practices and procedures of the Federal Home Loan Bank Board. In the weeks and months ahead we will investigate, in depth, the operations and activities of all of the Federal bank regulatory agencies.

First, we will explore whether the procedures and practices of Federal bank examiners are adequate for identifying and evaluating questionable banking practices. In this regard, the examiner evaluations of specific real estate construction and development and real estate investment trust (REIT) loans of four large commercial banks will be reviewed in detail.

Second, we will consider the supervisory and regulatory response to information and data generated by the examination process. The subcommittee wants to know whether the banking regulatory agencies act promptly and make full use of their legal powers to curb excessive risk practices by banks.

The subject of today's hearing is the "problem bank" list—What is it? How does a bank get designated as a "problem bank"? What specific supervisory steps are taken by bank regulators to get a bank off of the "list"? And what significance the public should associate with the designation of a bank as a "problem bank"?

The subcommittee has asked the Office of the Comptroller of the Currency to respond to these questions in a general way and with specific reference to the Chase Manhattan Bank and the First National City Bank of New York—which have been identified in press accounts as appearing on the Comptroller's "problem list."

The financial condition of some of our Nation's largest commercial banks has been the subject of concern and speculation during recent weeks and months. Preliminary research by the subcommittee suggests that the foundation of the weakened condition of our banking system was laid not during the recent recession, but during the late sixties, and was completed by 1973.

Indeed, a picture of the decline in bank soundness is clear in the trends in bank capitalization from 1969 through 1973. The most frequently used measure of bank soundness is the "capital to asset ratio." There are many variations of this ratio, but perhaps the most informative is the ratio of adjusted capital to total assets. Adjusted capital consists of shareholders' equity, loan and security loss reserves, and long-term debt, minus 100 percent of those assets classified by examiners as loss, and 50 percent of those assets classified as doubtful. This ratio involves examiner evaluations of bank loan assets and therefore has not formerly been available to the public. To make clear the trends that were underway and apparently acquiesced to by the bank regulatory agencies, during 1969 through 1973, the subcommittee is today releasing the 1969, 1971, and 1973 values of this key examination statistic for the 50 largest commercial banks in the United States.

[The information referred to follows:]

TRENDS IN THE RATIO OF ADJUSTED CAPITAL TO TOTAL ASSETS OF THE 50 LARGEST U.S. COMMERCIAL BANKS, 1969–73

Bank	Adjusted capital to total assets [1]		
	1969	1971	1973
Bank of America	0.064	0.048	0.049
First National City Bank	.109	.062	.058
Chase Manhattan Bank	.099	.069	.061
Chemical Bank	.088	.083	.056
Manufacturers Hanover Trust	.076	.071	.054
Continental Illinois	.089	.080	.066
Morgan Guaranty Trust	.098	.104	.074
Bankers Trust Co	.079	.082	.048
First National Bank of Chicago	.102	.086	.057
Security Pacific	.077	.064	.050
Wells Fargo Bank	.077	.063	.049
Crocker National Bank	.078	.063	.057
United California Bank	.077	.062	.055
National Bank of Detroit	.087	.070	.079
Mellon National Bank & Trust	.118	.105	.077
Irving Trust Co	.062	.062	.046
First National Bank of Boston	.089	.079	.062
First Pennsylvania Banking and Trust	.077	.071	.057
Franklin National Bank	.079	.065	.047
Union Bank	.084	.070	.060
Seattle First National Bank	.078	.064	.057
Cleveland Trust Co	.109	.116	.116
Harris Trust & Saving Bank	.102	.086	.066
Marine Midland Bank—New York	.051	.089	.040
Philadelphia National Bank	.087	.093	.079
Republic National Bank of Dallas	.087	.069	.052

TRENDS IN THE RATIO OF ADJUSTED CAPITAL TO TOTAL ASSETS OF THE 50 LARGEST U.S. COMMERCIAL BANKS, 1969-73—Continued

Bank	Adjusted capital to total assets [1] 1969	1971	1973
Valley National Bank of Arizona	.068	.070	.072
Wachovia Bank & Trust Co	.095	.099	.077
Detroit Bank & Trust Co	.073	.079	.074
North Carolina National Bank	.081	.082	.056
First National Bank of Oregon	.065	.073	.082
Citizens & Southern National Bank	.095	.091	.076
Manufacturers National Bank	.077	.077	.072
National Bank of North America	.087	.092	.086
Girard Trust Bank	.091	.088	.068
Northern Trust Co	.098	.074	.084
Bank of California	.059	.053	.050
United States National Bank	.070	.070	.081
First National Bank in Dallas	.102	.088	.066
First City National Bank of Houston	(2)	.080	.063
Pittsburgh National Bank	.094	.097	.093
Marine Midland Bank—Western	.083	.084	.077
First Wisconsin National Bank	.081	.064	.056
Fidelity Bank	.093	.093	.083
National City Bank	.102	.109	.091
First National Bank of Atlanta	.093	.085	.077
Security National Bank	.081	.073	.063
National Bank of Commerce (Seattle)	.075	.065	.058
First Union National Bank of Charlotte	.082	.071	.071

[1] Adjusted capital consists of shareholders equity, loan and security loss reserves, plus subordinated long-term debt less 100 percent of assets classified as loss and 50 percent of assets classified as doubtful. Total assets includes both foreign and domestic assets.
[2] Not available.

Mr. ROSENTHAL. Looking at the averages for the 20 largest banks, we find the adjusted capital to total assets ratio fell from 8.5 percent in 1969 to 7.2 percent in 1971 to 5.8 percent in 1973. The ratios of the five largest banks regulated by Comptroller of the Currency declined from 9.2 percent in 1969 to 6.9 percent in 1971 to 5.8 percent in 1973. The capitalization of the five largest banks regulated by the Federal Reserve declined from 8.3 percent in 1969 to 8 percent in 1971, to 5.7 percent in 1973. Several of the banks in this group have improved their financial condition since 1973; most have not.

Why the Federal regulatory agencies failed to halt the trend toward greater banking risk in the early 1970's and what they are doing now about the consequences of that trend, are among the questions this subcommittee will probe.

The Federal banking agencies—the Federal Reserve System, Comptroller of the Currency, Federal Home Loan Bank Board, and Federal Deposit Insurance Corporation—regulate almost 20,000 institutions with assets aggregating over a trillion dollars. They are probably the most important and least scrutinized regulatory agencies in Washington. While their mission goes to the very foundation of our economic system, they have operated under what I regard as an unwarranted cloak of secrecy. If recent events have taught us anything, it is that excessive secrecy in Government agencies leads inevitably to governmental inefficiency and abuse.

We hope these hearings will lift some of the veils from this regulatory system and that they will contribute to the effort to make Federal bank regulation more effective.

Our witness this morning is Robert Bloom, the First Deputy Comptroller of the Currency for Policy. Mr. Bloom appears in the place of the Comptroller of the Currency who is, I understand, in Europe on a previously scheduled official visit.

Mr. Bloom, we will hear from you now.

STATEMENT OF ROBERT BLOOM, FIRST DEPUTY COMPTROLLER OF THE CURRENCY FOR POLICY; ACCOMPANIED BY PAUL HOMAN, ASSOCIATE DEPUTY COMPTROLLER; AND C. WESTBROOK MURPHY, DEPUTY COMPTROLLER OF THE LAW

Mr. Bloom. Thank you, Mr. Chairman. I would first like to introduce two of my colleagues who are with me this morning. On my left is Mr. Paul Homan who is the Associate Deputy Comptroller. On my right is Mr. C. Westbrook Murphy, who is Deputy Comptroller for Law and Chief Counsel for our office.

I do have a prepared statement this morning which I do want to read because it goes into some detail on the subject of this hearing which is, as I understand it, the general nature of our examination process and how well we do it.

Before I start on the statement, however, I would like to comment on one item in your opening statement, Mr. Chairman. That is the reference to the declining ratio between capital and total assets. We were not given these charts previous to the opening of the hearing so I am in no position to comment on the accuracy of these numbers.

Adjusted capital, as I understand it, refers to the total capital of a bank less a certain amount for possible problem loans. Since I do not believe that information is generally released by the banking agencies, I have no idea where those numbers came from or whether they are accurate.

I would say in general terms, however, that it is certainly true that that particular ratio has declined in recent years. But to take that ratio and to say that that indicates a weakening in the banking system is a gross oversimplification.

The importance or significance of the ratio of total capital or adjusted capital to total assets or to total loans is a subject of much controversy among experts. There is no agreement as to which of these many ratios you can take as the most important in assessing the adequacy of capital or the soundness of an institution.

The only thing that I know of that all bank regulators agree upon is that that statistic is only meaningful when taken in conjunction with the rest of a bank picture—the quality of its management; the liquidity of its assets; its ability to earn, which is in today's climate the most important; the burden of its occupancy expenses; the volatility of its deposits; the quality of its operating procedures; and its general capacity to meet the financial needs of the trade area.

To pull one statistic out and to say that this indicates a decline in the soundness of a system cannot, I think, be justified.

I do not intend to go into details about particular banking institutions this morning, as was indicated to your staff; but, I will go to the extent of putting in the record the statements that were made by the Chairman of the Federal Reserve Board and by my boss, the Comptroller of the Currency, in the last few days and of the leading bankers. These are to the effect that the Nation's banking system is indeed sound. It has come out of a very difficult period during the recent recession with increased reserves for loan losses. They have weathered unusually high existing loan losses out of earnings and the picture is better today than it has been for quite a while.

With that, I would like to go to my prepared statement on the manner in which we examine banks and this whole question about the so-called problem banks.

In view of the recent newspaper articles on the subject of so-called problem banks, we think it is important to shed light on this topic since the publicity has tended to confuse rather than enlighten.

The term "problem bank" is a vague term which has become banking agency jargon without precise definition. If what is meant is a bank, the liquidity and solvency of which is in serious question, we hasten to assure you that very few national banks, and none of the money center national banks, are considered by our office to be "problem banks."

On the other hand, many national banks receive extra analysis and attention for a variety of reasons. The degree of supervision is determined through objective and subjective judgments made by field examiners, regional administrators and Washington staff. The Comptroller's Office maintains no list of such banks that could be characterized as a "problem bank list." Each bank is handled on an individual basis.

There is no magic formula or ratio which is capable of identifying banks for special supervision with any degree of accuracy. As a practical matter, however, we have used in the past a quantitative formula based on examination report data which identify those banks to be given further analysis at all staff levels. All banks with criticized assets, taking 100 percent of substandard, 50 percent of other loans especially mentioned, and 50 percent of the doubtful loans, aggregating 65 percent or more of adjusted capital funds. Adjusted capital funds means the equity accounts plus the reserves for loan losses and capital notes less losses and 50 percent of doubtful. These are given special analysis and attention by this office.

It is apparently a list of banks with classified assets over 65 percent of capital which was referred to in the Washington Post story as the Comptroller's "problem bank" list. As the Comptroller stated in his press release following the Post story, the labeling of every bank with a ratio of criticized assets to capital of 65 percent or more as a "problem bank" is a misstatement and oversimplification.

The volume of criticized loans in a particular bank, taken alone without further information as to the strength of management, earnings, liquidity, ability to raise additional capital, access to the money markets and other factors, is not significant. In addition, a great deal depends on the state of the economy during the period in question. The significance of classified asset ratios as a supervisory tool is obviously greater during prosperous times than it is during periods of recession such as 1974 and 1975. A ratio of 65 percent or more of classified assets in a prosperous economy could be reflective of poor management. A ratio of 65 percent or more during 1975 and at present does not necessarily reflect adversely on management. It is common knowledge in financial circles that many banks, both large and small, well managed and poorly managed, today have ratios in excess of 65 percent to capital. Indeed, any bank whose volume of criticized loans did not increase during 1975 probably had not been performing the normal risk-taking functions through which a commercial bank serves its community.

And I think we should remind the public that this ratio we are talking about is the ratio of classified loans to capital, and not to total assets or total loans. I think that when some people look at these percentages of 65 or of 90 percent that they think 90 percent of the bank's loans are no good. But as a matter of fact, the actual percentage of a bank's total loans that we are talking about is somewhere in the range of 1 percent or 2 percent or 3 percent. This ratio is classified loans to capital, not classified loans to total loans. And while we all understand that, I am sure that some of the readers of the newspapers have not understood that. These percentages have looked alarmingly high to them when what we are really talking about is a really small percentage of the bank's assets or loans.

There are two principal aspects in singling out banks for special supervisory attention. First, there are the procedures and criteria to be used in identifying such banks; and second, there are the procedures and methods for correcting whatever deficiencies exist in such banks. This office is now engaged in a major revision and improvement of its operations in both of these areas, based largely on the recommendations of Haskins & Sells, an outside consulting firm retained by the office in May 1974. The Haskins & Sells recommendations have been published and copies of the report have been sent to each Member of Congress.

I would like to describe briefly our existing grading systems. Under the traditional system for pinpointing banks for special attention, a great deal of emphasis was placed on the ratio of classified assets to gross capital. Classified assets are those assets which are singled out by the examiner as having credit weakness of varying degrees of intensity. The classifications in ascending order of severity are other loans, especially mentioned (OLEM), substandard, doubtful, and loss. Banks are graded in four groupings according to the ratio of assets classified as loss, doubtful, or substandard to gross capital funds. The four groupings are: group A—zero to 20 percent; group B—20 percent to 40 percent; group C—40 percent to 80 percent; and group D—80 percent or more.

In addition to the above classified asset categories, the examiners rate capital adequacy on a 1-through-4 scale taking into account the other factors of quality of management, the liquidity of assets, the history of earnings, the quality and character of ownership, the burden of meeting occupancy expenses, the potential volatility of the deposit structure, the efficiency of operations, and certain competitive factors. However, in that they are still starting out with a tilt based on that ratio which they got in the first measure. So in actual practice, a bank that starts out in group C or group D in connection with its classified assets will find the examiner especially hard in analyzing these other factors.

Bank management is rated as well in three categories. These are: strong, fair, or poor. After these three ratings are assigned, the examiner assigns a composite or group rating to the bank. Group 1 banks are those considered to have good capital, competent management, good operations, good liquidity, and less than 20 percent of classified assets to gross capital. On the other end of the spectrum, group 4 banks include those which could be approaching insolvency, thus requiring immediate injection of capital, new management, or both.

But it can be seen that, throughout the gradings, a tremendous emphasis is given on the ratio of classified loans to capital.

In the past, this office has maintained lists of banks falling within groups 3 and 4 as described above. For your information, a schedule is attached to this statement which reflects the number of banks on these lists from July 5, 1972, to July 1, 1974. Such lists, because of the primary emphasis placed on the volume of classified loans, are not considered under present economic conditions as particularly meaningful. This Office still reviews each examination report on a case-by-case basis, and, after discussions with our regional administrators and the national bank examiners, determines whether or not additional supervision is necessary. In those cases where it is decided that such supervision is required, personnel from Washington work closely, in some cases on a daily basis, with personnel in the region and with personnel from the bank.

[The schedule referred to follows:]

Date of list	Total number of national banks	Number of banks on list	Banks listed [1]	Date of call reports	Total assets (millions)	Total deposits (millions)	Total assets of bank on list [2]	Total deposits on bank list [3]
July 5, 1972	4,607	122	2.6	June 30, 1972	18,661	15,222	4.8	4.7
Jan. 10, 1973	4,614	110	2.4	Dec. 31, 1972	21,796	18,282	5.0	5.1
July 3, 1973	4,629	94	2.0	June 30, 1973	21,095	16,723	4.7	4.6
Jan. 11, 1974	4,661	109	2.3	Dec. 31, 1973	22,924	18,146	4.7	4.6
July 1, 1974	4,695	133	2.8	June 30, 1974	42,086	31,282	8.1	7.7

[1] As percent of total banks.
[2] As percent of total assets of national banks.
[3] As percent of total deposits of all national banks.

Mr. Bloom. Now I would like to turn to the new system which we are developing and which we hope will give us an earlier and a clearer and a more accurate way of singling out banks for special supervision.

The new system will be a computerized "early warning system" called the national bank surveillance system—which we call NBSS. This will consist of four basic elements: (1) A data-collection system; (2) a computer-based monitoring system that would detect unusual or significantly changed circumstances within a bank and within the national banking system; (3) an evaluation by experienced personnel of the impact of such changes on bank soundness; (4) a review procedure that would provide administrative controls over all proposed remedial actions, including those of Washington personnel.

A Deputy Comptroller of the Currency and a project manager from Haskins and Sells initiated the NBSS in September of 1975. Their efforts were directed toward steps one and two, a data-collection system and a computer-based monitoring system. They also have begun work on step three by selecting experienced examiners who will analyze the importance of the computerized data.

The data which have been reported to the three Federal regulatory agencies by their respective banks have traditionally been utilized for historical and statistical purposes. Major portions of this data have, by joint agreement of the three agencies, been stored in the FDIC's computer. Since this office decided to use that data for supervisory purposes, one of the first steps in creating the NBSS required the transfer of portions of the data in the FDIC's computer to a data base in a separate computer which could be used by our office for supervisory purposes. The data has been transferred and it essentially covers the condition and income reports of national banks during the past 5 years.

Three additional steps are being taken to improve and expand the data base. First, we are conducting frequent, almost daily, discussions with representatives of the Federal Reserve and the FDIC to amend the banks' condition and income reports so that the facts in these reports will be more meaningful for supervisory purposes. When information desired by this office is not deemed necessary by the other two regulators, we will acquire that data through special reports submitted by the bank separately from the customary call and earning reports. Second, certain portions of the nonpublic reports of examination will be included in our data base. Third, if all of this data is to be analyzed on a timely basis, it must be processed rapidly. To accomplish this objective, the Management Services Division of the Comptroller's Office has made two trial runs on the direct processing of NBSS data from reports of condition and has concluded that this data can be processed within 45 days of the date of the call in lieu of the 5-month period normally required for the combined production by the three Federal bank regulators.

The NBSS will work with banks that are segregated into peer groups in our data base. The statistical trends of each peer group and of each bank within the peer group will alert our office to exceptional banks or groups of banks on no less than a quarterly basis. In view of today's rapidly changing economy, this system will be more timely than the traditional system of supervision through the receipt of reports of examination which are required only three times in each 2-year cycle.

The fourth element of the system involves an administrative review procedure or monitoring system which would stem from the quarterly analysis of data. The review and monitoring system will enable a staff of experienced examiners to make recommendations on a bank-by-bank basis to each of 14 Regional Administrators as to the type and scope of examination which may be required promptly for individual banks. The monitoring system will also be computer assisted to the extent that the recommendations and the reactions, both positive and negative, by both examiners and bankers will prompt successive steps of recommended corrective action as needed.

What we are developing is an NBSS which will serve the regulator and the banker in maintaining a sound financial system to serve the public needs. The NBSS will help in the detection and the correction of impending problems before they become serious cases. This system will neither eliminate the human element from bank regulation nor will it eliminate the human element from the management of banks. It should, however, substantially aid in the prevention of future bank failures.

Now I would like to discuss what we do when we find problems. Once significant problems of a national bank have been identified through the examination process, the examiner commences the supervisory action process by commenting in the report of examination on important matters requiring attention of the Comptroller, the Board of Directors, and the active executive management. The examiner also will get a great deal accomplished on the spot. Before he leaves the bank, many matters needing correction will be corrected while he is there and some of these will not be included in the report. The remaining criticisms are supplemented by a letter from the Regional Administrator which highlights the bank's problems and requests the Board of Directors and executive management to institute appropriate corrective measures. Depending on the circumstances and the severity of the problems, the bank's executive management may be requested to submit monthly reports regarding progress it has made toward improving unsatisfactory areas of the bank. In addition, frequent visitations and examinations may be conducted.

When an examination or special visitation of a national bank discloses a condition so unsatisfactory as to warrant that the Board of Directors should be promptly and personally informed, a special meeting with the Board is called by the examiner or his Regional Administrator. Special representatives of the Comptroller's Office may attend the meeting depending on the circumstances and severity of the problem. The objectives of meeting with a Board of Directors are to discuss the conditions and affairs of the bank that were observed during the most recent examination, to reach an agreement of any significant problems in the bank, to obtain a definitive commitment from the Board of Directors, to institute the proper corrective actions, and to obtain information concerning future plans and proposed changes in bank policy that may have a significant impact on the future condition of the bank.

Bank supervision provided at the regional level is coordinated with the Washington staff which provides additional legal assistance, coordination with other regulatory agencies, attendance at board meetings, analytical support, and followup review. Where the facts indicate a serious problem, a possible violation of law, or unsafe and unsound practices, we may call upon the Enforcement and Compliance Division of our Law Department. This assistance may consist of the attendance of an attorney from the Enforcement Division at a Board of Directors meeting to discuss with the bank the problems and the suggested corrective action. In other cases it may require the investigation by the Enforcement Division to determine whether sufficient facts justify the commencement of a cease and desist proceeding or the certification to the Federal Reserve Board for removal of an official or the making of a criminal referral to the Department of Justice. In the latter two situations, the investigation must disclose that the particular activities of an individual constitute evidence of personal dishonesty.

In addition the bank must come to the Comptroller for approvals of various corporate changes, such as the opening of a new branch, payment of dividends, investments in premises and other approvals. The Comptroller may withhold his approval on such applications until he is satisfied concerning the responsiveness of a bank to his recommendations.

In determining the appropriate remedy for a particular bank, the Comptroller, together with the Deputy Comptrollers, Regional Administrators, examiners and the Legal Division, must determine which type of action will be the best rehabilitative type of remedy to assist the bank. Where the facts indicate that there are serious problems or that there are repeated violations of law or unsafe and unsound practices, this office has a wide range of administrative remedies to deal with the situation. These remedies, however, are not punitive but are of a rehabilitative nature. One of the principal remedies available to the Comptroller is the power given under the Financial Institutions Supervisory Act of 1966 to commence cease and desist proceedings. Cease and desist proceedings are rehabilitative, intermediate tools which allow the Comptroller to force a bank to work out its problems without resorting to the more drastic remedies of receivership, conservatorship, termination of insurance, forfeiture of charter, or forced merger with another bank. Our experience has indicated that the threat of a cease and desist proceeding enables this office to handle the majority of bank problems through the less formal techniques of persuasion, frequent examinations, and meetings with directors.

Of course, the success of all these efforts will depend on the quality of information we receive. While our examiners independently search for information in examining banks, much information has to be derived from a candid exchange of views with bank directors and officers and other members of the public conducted on a strictly confidential basis. If the rules are changed to require public disclosure of what is in the examination report, there is no doubt that we will be hampered considerably in obtaining a complete picture of national banks. Likewise, the disclosure of which banks are subject to special supervision will make correction of problems incomparably more difficult, if not impossible, in some cases.

The confidentiality of Government examinations, however, does not impair the public's right to obtain necessary financial information about banks. Banks are subject to the disclosure provisions of the Securities Exchange Act of 1934 to the same extent as are other publicly held companies. In addition to what nonbank corporations must disclose, banks must publish quarterly a report of condition, a call report, which includes both balance sheet and income and expense information. The three Federal banking agencies have recently increased substantially these disclosure requirements. Beginning with the March 31, 1976, report of condition, banks will be disclosing publicly more financial information than any other major category of publicly owned companies.

As I told Mr. Dugger, when he delivered the subcommittee's letter of invitation, we will have to decline this morning to comment specifically on the affairs of any particular bank, including Chase Manhattan Bank and First National City Bank. To violate confidences which we have elicited in order to investigate more thoroughly these and other banks would run counter to the venerable congressional policy of protecting the confidentiality of bank records and examination reports. This policy is set forth in numerous statutes which we have cited in our statement, including the Freedom of Information Act, the Criminal Code, and the National Bank Act, as well as the Financial Institutions' Supervisory Act of 1966.

That concludes my statement, Mr. Chairman.

Mr. ROSENTHAL. Thank you very much, Mr. Bloom.

In anticipation of your declination of the information as to specific examination reports and specific information concerning the two banks, Chase Manhattan and First National City Bank, about which there have been reports, I asked the American Law Division of the Library of Congress to prepare a legal memorandum as to the subcommittee's authority in this area to require you to deliver this information to this subcommittee.

It is a very lengthy memorandum and I will have a copy sent to you for your comments. But let me read to you a conclusion that is contained therein. "Thus it is quite clear that your subcommittee's broad oversight mandate which specifically includes the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency, entitles it to exercise plenary investigative and information gathering authority unless some other statutory restriction or constitutional privilege may be raised to limit that power."

It goes on further:

> We find no provision in the enabling statutes of the three subject agencies which either by virtue of expressed language or necessary implication restricts access by duly authorized committees of Congress to information held by any of those agencies.

I have reviewed all of the statutes that you have cited and none of them, in my judgment, gives you the authority to decline to give this information to the subcommittee. Therefore, I am calling upon you now to deliver to the subcommittee at this session the information contained in the letter of January 14, 1976.

I will read some of the items which are currently contained in your declination. Item 4: Since 1965, how many separate banks have been included on the "problem bank" list? How many banks were included thereon for each year and what is the present status of those banks?

Item 5: What are the types of recommendations made and/or actions taken by your office as a result of a bank's inclusion on the "problem" list? What powers do you have to insure compliance with your recommendations?

Item 6: What comments and/or notices were given to Chase and City Bank by your office regarding their inclusion on the ilst of problem banks?

Item 7: What was Chase or City Bank's response to the comments, notices, or recommendations referred to in item 6 above?

Item 8: What is your view as to the necessity for confidentiality from the public regarding the bank examination reports and the problem list?

The letter continues: "In addition, please be prepared to comment on the details of the examination reports from Chase and City Bank from 1970 to the present and recommendations emanating therefrom."

As I have said earlier, I have read every single one of the statutes you have, including the freedom of information section which specifically excludes information not to be turned over to committees of Congress. It is my opinion that you must give this information to us. Are you prepared, either in public session or in closed session, to do this?

Mr. BLOOM. Mr. Chairman, before we get into a legal debate on that, I think we can narrow this issue. As you went over these paragraphs of your letter, I see a couple which we have certainly in good faith attempted to answer in our statement and others which I may be able to answer because of the nature of the answer, as you will see.

It is not until you get down towards the end of your letter where you ask for comments on the details of the examination reports that we really have a legal issue.

Could I do that? May I answer your letter by going down these paragraphs?

Mr. ROSENTHAL. Surely.

Mr. BLOOM. I will point out the ones that we have answered to the best of our ability so that we can at least establish what we are talking about.

Mr. ROSENTHAL. We will be delighted to do that. I merely want to get the procedure straightened out because we may have some parliamentary situations up on votes that the subcommittee will have to take this morning.

I am calling upon you for all of the information contained in that letter—every bit of it, including the information of the examination reports on Chase and on City Bank. Are you prepared to give it to us today either in open session or closed session?

Mr. BLOOM. Not the examination report information; no.

Mr. ROSENTHAL. Is it your presentation that you are refusing to give those examination reports on Chase Manhattan Bank and City Bank to this subcommittee?

Mr. BLOOM. Yes, sir.

Mr. ROSENTHAL. Either in open session or in closed session?

Mr. BLOOM. Yes, sir.

Mr. ROSENTHAL. We will entertain a motion to go into closed session if you are prepared to give it to us in closed session. If you are not, we will not even consider that motion and proceed accordingly.

Mr. BLOOM. We are not prepared to do it in closed or open session.

Mr. ROSENTHAL. I want you to know that the subcommittee will pursue all of the rights and remedies, including a subpena and all that follows residually from the issuance and declination of response to a subpena.

Do you understand that?

Mr. BLOOM. I understand that, Mr. Chairman. If you wish, I could state the reasons why we are taking this. It is not out of any lack of respect for this committee, I assure you.

Mr. ROSENTHAL. If you would like to state the reasons, you are at liberty to do so. Please do not cite the statutes that have already been cited. If you have some new material, it might be useful.

Mr. BLOOM. I think that the law is certainly one of the reasons.

Mr. ROSENTHAL. If you want to cite the statutes, read them so that all of the members of the subcommittee can hear them. Then we will call upon the attorney who wrote this memorandum to respond.

Mr. BLOOM. I don't know whether we could do that here. We could have a legal debate. I have my counsel here with me. If you want to take the time to do that here, we could do that.

However, there are two additional reasons which I would like to put on the record. In addition to our perception of what the congressional intent at the present time is in connection with examination reports and public disclosure and disclosure to congressional committees, we are not prepared to do it because it would represent a complete breach of our confidence with 1,800 bank examiners and 4,-600 banks.

These bank examiners and bankers have talked to each other under the assumption and under the understanding, which has been the practice for over a century, that their personal and confidential comments—the examiner's comments to the Comptroller about the banker and the banker's comments to the examiner about his bank and about his borrowers and about his colleagues in the bank—will not be public information.

To change the rules of the game without also warning these people that these rules have been changed, we would consider completely unfair and a breach of confidence to these thousands of people. That is our second reason in addition to the law.

Mr. Rosenthal. Is it your view that those relationships supersede established statutory law?

Mr. Bloom. It is our view, and I do not think there is any doubt about it, Mr. Chairman, that those relationships are embodied in the law. Those relationships could not have existed for 110 years in defiance of the law in our opinion.

Let me state the third reason which I think is a bit of a show-stopper. That is that I am not authorized to talk about individual banks this morning. I am not the Comptroller of the Currency. I am the Deputy Comptroller of the Currency.

Mr. Rosenthal. Did he tell you before he left for Europe that you were not to release this information—even under the threat of contempt?

Mr. Bloom. He did.

Mr. Rosenthal. He did do that. I want to step back for a second to be sure that I and the press and the public understand your position clearly. You are saying that the special relationships that have existed for 110 years take precedence over statutory law.

Mr. Bloom. I am not saying that. I have just said that they are in the statutory law. Those relationships embody the statutory law.

Mr. Rosenthal. Could you cite the section of the law in which those relationships are embodied and set forth specifically?

Mr. Bloom. I think I will allow my counsel to do this.

Mr. Rosenthal. We would be delighted to hear from anyone who is sufficiently ingenious to do that.

Mr. Murphy. If you will look, Mr. Chairman, to the basic statute giving us authority and responsibility to examine national banks, found in 12 U.S.C., section 481, you will find a procedure there for the publication of examination reports. That statute says that the Comptroller is authorized to publish examination reports only upon two conditions: (1) That he has called to the bank's attention the deficiencies noted in the examination report and that the bank within 120 days has failed to correct those deficiencies; (2) following that 120-day period, if those deficiencies still remain uncorrected, then 90 days' prior notice must be given to the bank before the examination report is published.

Mr. Rosenthal. Where does it say anything about disclosure to congressional committees?

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Mr. MURPHY. There is nothing in that about disclosure to congressional committees. But I do think that we can imply from that statute a general assumption that these examination reports are not to be disclosed or made public.

Mr. ROSENTHAL. Let me read to you section 1906:

Whoever being an examiner, public or private, discloses the names of borrowers or the collateral for loans of any member bank of the Federal Reserve System or bank insured by the Federal Deposit Insurance Corporation examined by him to other than the proper officers of such bank without first having obtained the express permission in writing from the Comptroller of the Currency as to a national bank, the Board of Governors of the Federal Reserve System as to a State member bank, or the Federal Deposit Insurance Corporation as to any other insured bank or from the Board of Directors of such bank, except when ordered to do so by a court of competent jurisdiction or by direction of the Congress of the United States or either House thereof or any committee of Congress, of either House, duly authorized shall be fined not more than $5.000.00 or imprisoned not more than one year.

That to me is an overwhelming mandate that takes precedence over all of the unwritten law that you suggest has been statutoricized by friendships of a hundred or more years.

Mr. MURPHY. If you will pardon me, Mr. Chairman, I think that is a mischaracterization to say friendships of a hundred or more years. I do not believe that is what Mr. Bloom said.

Mr. ROSENTHAL. Will you tell me what he said?

Mr. MURPHY. I do not believe that in my tenure in the Comptroller's Office of about a decade that we have with this committee or with any other committee asserted that a congressional committee did not have proper authority by a duly authorized resolution, possibly with or without a subpena, to obtain documents from our office. What we have attempted to do is to point out that there are a good many statutes with some of them going back more than 100 years giving confidentiality to those examination reports. We think those statutes embody a good deal of public policy which ought to be carefully considered by a committee before it takes the unusual action of attempting to delve into the particular affairs of a particular bank. And I think that the misunderstandings that can result from having one, for us, fairly routine report published about any particular bank can be illustrated no better than by what has happened in the last 2 weeks in the Washington Post.

Mr. ROSENTHAL. We are prepared to accept all of this information that I have requested in closed session here this morning. Are you prepared to recommend to your colleague, associate, or client that he comply with that request? If not, we will not proceed to a vote to close the session. I think you have already answered in the negative. Is that correct?

Mr. BLOOM. That is correct.

Mr. ROSENTHAL. Then why don't you go ahead and respond to those areas that you feel competent or willing to respond.

Mr. BLOOM. All right, Mr. Chairman.

Beginning with paragraph No. 4: How many separate banks have been included on the "problem bank" list since 1965? How many banks have been included thereon for each year and what is the present status of these banks?

We have attempted to answer that. We have a table which shows that information for the years of 1972 through 1974. We are not able to go back to 1965 because our file was kept in a way which does not enable us to reconstruct it. It was in a card index. It showed banks on the list, but it did not show the periods when the bank was off the list and when it was on the list. We were not able to reconstruct that information earlier than 1972.

As far as the most recent year is concerned, we have a difficulty in the opposite direction. As I indicated in my main testimony, we have discontinued the list in question. In other words, the list you are talking about which refers to the so-called group C and group D banks is no longer maintained. But we are attempting to reconstruct it. And if possible, the chart that has been submitted will be brought up to date.

In connection with paragraph 5, I believe my statement atempted to answer that. That was: What are the types of recommendations made and actions taken by our office as a result of a bank's inclusion on the "problem list?" I did not put it in terms of a "problem list," but obviously the recommendations and the disciplinary corrective actions would be the ones which I indicated. I think I covered all of the ones that are in our arsenal.

The questions in No. 6 and No. 7 regarding whether we gave Chase and City notice that they were on a problem list and what were their responses to our notice is, in its terms, within our restricted area. However, the answer to the question does not involve any violation, I don't think, of any confidence for the simple reason that the answer to the first question is that no notices were given to Chase or City because we did not have a "problem list" as such. There was no information of that sort that we could impart to them.

The question assumes the existence of a problem list. We have lists of banks that have particular problems. I know it sounds like a semantic difference and like hair-splitting, but it isn't. There really is a difference between a bank with problems and a bank that is in danger of folding. That is, unfortunately, what the public, in our experience, attaches to the phrase "problem list." So it is more than a semantic difference.

So since the answer to No. 6 is that there was no such list, there was no such communication to Chase and City; the answer to No. 7 is obviously negative because they could not respond to a communication they never received. That takes care of 6 and 7.

Mr. ROSENTHAL. On page 1 of your statement, you say that there may not be a "problem list," but that there are problem banks. How many problem banks do you have under your supervision right now?

Mr. BLOOM. I did not say that there are problem banks. I said there is no problem list. I said the use of "problem banks" is a misnomer. It is jargon that we throw around. It means many things to many people. Some people refer to it as banks which are a problem to the agency or a problem to that particular individual. Other people use the phrase for banks that have problems. So I cannot say that there is a list of "problem banks" as such in our office.

Mr. ROSENTHAL. I have one other question before we get into the specifics. I remember some months ago when there was a leak of personal interest rates in the Federal Reserve Board. The Chairman of the Federal Reserve Board asked the Federal Bureau of Investigation to conduct an inquiry as to how that leak occurred and to see if they could ascertain responsibility. Have you folks done anything about this recent information that has been appearing in the press?

Mr. BLOOM. We have referred the matter to the Criminal Division of the Department of Justice for whatever action they deem appropriate.

Mr. ROSENTHAL. Is there an ongoing FBI investigation?

Mr. MURPHY. There is an ongoing investigation. Whether the FBI is involved at this time, I do not know.

Mr. ROSENTHAL. Is the CIA doing it? Do you know?

Mr. BLOOM. No.

Mr. ROSENTHAL. Who is doing it?

Mr. BLOOM. We are doing it internally.

Mr. ROSENTHAL. You have your own internal security investigation going?

Mr. BLOOM. Yes, sir.

Mr. ROSENTHAL. And you have also referred it to the Justice Department?

Mr. BLOOM. Yes, sir.

Mr. ROSENTHAL. Who do you think they have asked to look into it?

Mr. BLOOM. I don't know.

Mr. ROSENTHAL. As a lawyer, could you take a guess?

Mr. BLOOM. If they asked anybody to look into it, they would ask the FBI. But I don't know whether they have or not, Mr. Chairman.

Mr. ROSENTHAL. Did you ask them to ask the FBI to look into it?

Mr. MURPHY. May I respond, Mr. Chairman. We have undertaken our own investigation within the agency as to where the documents may have come from. Circumstances indicate a possible violation of the criminal statutes. You read one of those statutes just a few moments ago yourself—18 U.S.C., section 1906. Whenever we have indication that a criminal statute may have been violated, we believe it is our duty to refer that possible crime to the Department of Justice. We have done so by a reference to the Assistant Attorney General in charge of the Criminal Division.

What action he has taken on it and to whom he has referred it for investigation, we are unaware.

Mr. ROSENTHAL. Have you spoken to the Assistant Attorney General since your letter of referral?

Mr. MURPHY. We have been in communication with his staff; yes, sir.

Mr. ROSENTHAL. Has his staff told you who is looking into it?

Mr. MURPHY. I do not know, sir.

Mr. ROSENTHAL. Has the staff told you who is looking into it?

Mr. MURPHY. They have not told me personally; no, sir.

Mr. ROSENTHAL. Did they tell you anybody was looking into it?

Mr. MURPHY. As I say, we have been in communication. I am not aware of the substance of that particular communication.

Mr. ROSENTHAL. You personally have not been in communication?

Mr. MURPHY. That is correct, sir.

Mr. ROSENTHAL. It was someone else in your office or in the Comptroller's Office?

Mr. MURPHY. That is correct.

Mr. ROSENTHAL. Mr. Bloom, what is meant by the terms "substandard," "other loans especially mentioned," "doubtful," and "loss"?

Mr. BLOOM. They are gradations of credit weakness in a loan. The standard explanation that is in the Examiner's Manual defines a "substandard asset" as a bank asset inadequately protected by the current sound worth and paying capacity of the obligor or pledged collateral, if any. While assets so classified have positive and well defined weaknesses, they are not considered by the examiners to have loss exposure.

"Other loans especially mentioned" are loans currently protected, but potentially weak credit risks. Loans or assets of this type seldom result in loss to a bank.

"Doubtful" loans are subject to all of the weaknesses inherent in an asset classified "substandard," yet the weaknesses are pronounced to a point where collection or liquidation in full is highly questionable.

A "loss" loan is one which is considered uncollectable and of such little value that its continuance as an asset on the books of the bank is not warranted.

Mr. Rosenthal. What is the significance of the 65-percent level, and how is this level decided upon?

Mr. Bloom. There isn't a great deal of significance to it. It was decided upon because we had to have some dividing line between the banks whose classified assets had reached a point where we should single them out for special attention and special following and those which had not. It was only an arbitrary decision on our part. We could have put the cutoff point at 75 or 85. In today's loan climate, this type of ratio to capital is not at all uncommon—even in very strong banks.

Mr. Rosenthal. The subcommittee recognizes that 1974 and 1975 are not representative, but how do you explain the declines in capitalization and the overall increase in the level of risk in the banking system from 1969 through 1973?

Mr. Bloom. I think that that is a rather complicated financial question, but I will attempt to give my own view of it. It results from a number of different factors interacting. One of the most important, of course, is inflation. In other words, the numbers of a bank's loans and deposits were rapidly going up while its capital is a more static number.

Mr. Rosenthal. I remember reading a statement by Governor Bucher, of the Federal Reserve Board, in which he referred to an era of "go-go" banking. Does that have something to do with this?

Mr. Bloom. I don't think so because the banks that are in the strongest position today are the ones that have the strongest earning capacity to absorb these unusually high losses in the loan portfolios. I don't know exactly what you mean by "go-go" banking.

Mr. Rosenthal. He used the word.

Mr. Bloom. Who used the word?

Mr. Rosenthal. Governor Bucher, of the Federal Reserve Board, used the expression.

Mr. Bloom. I don't know exactly what he meant by the term. But if he meant aggressive banking of the type that City Bank is usually considered the leader in, I would say I only wish that all of our banks had the earning capacity of City Bank to take care of problems.

The question of the declining capital ratio, I think, has to be looked at in terms of what banks have been able to do during this period. At the same time that these ratios have been declining, their total earnings have been increasing. If you take the top 25 banks, which also happen to be bank holding companies, in 1973 they had provisions for loan losses of $417 million. They had actual loan chargeoffs of about the same amount. In 1974, their provisions for loan losses at the end of the year were up to $942 million. Their actual chargeoffs were up to $687 million.

In the first 9 months of 1975, their provisions for loan losses were up to $1,285 million and their actual chargeoffs were approximately $1 billion.

These same 25, for the first 9 months of 1975, had a total net before taxes and loan loss provisions of $3,900 million. The provision, as I have said, for the first 9 months for loan losses was $1,285 million. They paid $984 million in income taxes, they distributed cash dividends of $592 million, and they had a net addition to their capital accounts of over $1 billion. This was in one of the worst years of the recession.

Mr. ROSENTHAL. The list that we released today showing "adjusted capital to total assets" defines "adjusted capital" as consisting of shareholders equity, loan and security loss reserves, plus subordinated long-term debt, less 100 percent of assets classified as "loss" and 50 percent of assets classified as "doubtful." That really represents a cushion against insolvency. In other words, if for any reason there is a major run on any one or a series of banks, their reduction in adjusted capital makes them more susceptible to serious problems. Is that not correct?

Mr. BLOOM. Mr. Chairman, capital, as a cushion against insolvency, in my experience which has been limited to 15 years in the Comptroller's Office, has been strictly an academic matter. I have never seen a problem bank of the serious type—in other words, I have not seen a single insolvency where the bank's capital position would have made a difference.

In other words, if their ratios were up to the most conservative ratio imaginable, a bank that experiences loss of public confidence and therefore loss of its liquidity is going to be insolvent. Capital is, in my opinion, more of a textbook indicator than it is a pragmatic indicator or a real cushion.

Banks are the most highly leveraged business in the world. There is no question about it. They work almost solely with borrowed money. Deposits are borrowed money. So the difference between a 0.5 capital ratio and a 0.7 or a 0.8 is never going to save a bank from insolvency, in my opinion.

Mr. ROSENTHAL. Would it bother you if capital were reduced further by these major 50 banks in the United States, or is it of no concern to the Comptroller of the Currency?

Mr. BLOOM. I wouldn't say it is of no concern, but it is only one of a dozen indicators which are probably of equal importance.

Mr. ROSENTHAL. What is meant by a composite ratio of "2 DP/3"?

Mr. BLOOM. I tried to explain each one of those components in my statement. I will ask Paul Homan, who has been a bank examiner, to back me up on this explanation.

Mr. ROSENTHAL. Maybe Paul can tell us what "2 DP/3" means.

Mr. HOMAN. On the top of the scale, the first rating is capital position which is rated, as explained in the statement, on a 1 through 4 basis. So 2 would be the second rating there.

The "3" is the quality of assets. This is rated as A, B, C, or D—based on 0 to 20 percent, 20 percent to 40 percent, 40 percent to 80 percent, and 80 percent or more.

Mr. ROSENTHAL. If a bank has "D" as the quality of its assets, that is not so good.

Mr. HOMAN. That means that it has classified assets in excess of 80 percent of its gross capital funds.

Mr. ROSENTHAL. Translated into simple English, what does that mean?

Mr. BLOOM. It doesn't mean anything but what it says, Mr. Chairman. It means that a bank has classified assets in excess of 80 percent of its capital funds. It does not mean anything in addition to that.

Mr. ROSENTHAL. In simple English, what does that mean? What does "classified assets" mean?

Mr. HOMAN. That is the sum total of substandard, doubtful, and loss classifications in the examiner's report.

Mr. ROSENTHAL. And that means things are not so good, doesn't it?

Mr. HOMAN. Not necessarily.

Mr. ROSENTHAL. Things are beautiful?

Mr. HOMAN. If all of the classifications are in substandard categories, it means that the examiner has estimated no loss to that bank. So it depends upon the composition of those assets. It is merely a trigger mechanism to bring it to the attention of the examiner's regional administrator and the Washington office.

We then look underneath and look at the composition of those assets.

Mr. ROSENTHAL. What does "P" mean?

Mr. HOMAN. "P" is poor management. Management is rated on a scale of 1 through 3.

Mr. ROSENTHAL. What does "/3" mean?

Mr. HOMAN. The slash is the overall group rating. The "3" means the overall group rating, taking into account the capital position, the quality of assets, and the management. It is the composite rating of the first three.

Mr. ROSENTHAL. Did either of the banks referred to on page 11 of Mr. Bloom's statement have a rating of 2 DP/3?

Mr. BLOOM. Mr. Chairman, we are not going to go into ratings of individual banks—although I think this particular 2 DP/3 has been all over the Washington Post.

Mrs. COLLINS. He did not ask for a specific bank. He asked if either of the banks in that chart that you gave us had that classification.

Mr. BLOOM. Do you mean any of the banks in the chart?

Mr. ROSENTHAL. I meant either of the two banks named on page 11. Did either of those two banks have that rating?

Mr. BLOOM. Do you mean Chase or City Bank?

Mr. ROSENTHAL. Those are the ones on page 11.

Mr. BLOOM. You are asking us to comment on the examination reports. The stories that appeared in the Washington Post. You are asking me, in effect, if the stories are accurate.

Mr. ROSENTHAL. I am not interested in the Washington Post. I am asking you directly if either one of the banks listed on page 11 had a rating by the Comptroller of the Currency of 2 DP/3.

Mr. BLOOM. I will have to respectfully decline to answer that. You are in the area of specific banks.

Mr. ROSENTHAL. You are in the area of contumacious conduct. Do you know that?

Mr. Bloom. I don't think so, Mr. Chairman, I don't intend to be contumacious.

Mr. Brown. That is the chairman's personal opinion.

Mr. Rosenthal. That is this chairman's opinion as of this moment. I intend to pursue it accordingly under the Rules of the House of Representatives.

Mr. Brown, you may proceed.

Mr. Brown. Thank you, Mr. Chairman. First of all, let's get back for a moment to the statute which Mr. Rosenthal discussed. To my knowledge, that section provides that this information shall not be released, and it is a crime to release it except when ordered by a court of competent jurisdiction or by direction of the Congress of the United States or either House thereof or any committee of Congress.

To my knowledge, there has not been a vote authorizing the release of that information by a court of competent jurisdiction or by the Congress of the United States or either House thereof, nor by any committee of the Congress. There has not been a vote by this subcommittee; there has not been a vote by the full committee to authorize the release of that information.

I think that if you did not take the position that you have taken here this morning that you, in effect, would be doing an unauthorized act. You have not been authorized by any of those statutory authorities to release that information. To that effect, the chairman, in asking you to do what he is asking you, would be asking you to commit a violation of title 18, section 1906.

Mr. Murphy. That has been our longstanding understanding of that statute.

Mr. Brown. So let's get that straight first.

Mr. Bloom, it is fascinating to me and almost as if the Congress is schizophrenic. I sat here in this very room and on this very same subcommittee when Abe Beame came in here. The chairman sympathized with him. But in a prepared statement, he criticized the commercial banks of New York for not having involved themselves more with the financing of New York's problems. He referred to, as I recall, the banks' wanting to look at their budget as improper meddling by commercial banks.

Frankly, I did not support the chairman's position at that time or the commercial banks' position or Abe Beame's position in wanting to get into New York investments because I think it did involve risk. There is no question but that if these two banks have a problem in their portfolios, it is partially because they were trying to do a service to New York City. And I don't think you can be on both sides of that fence, but this committee obviously is.

They criticized commercial banks for not getting into the risk area to help New York City. But now they turn around and say, "You are stupid for having done it." And they bring you in and say that you should have been much more critical, apparently, of the activities of the banks with respect to some of their investments.

Now, you have been talking about these different categories. I think that you have been saying that the capital assets of a bank are insignificant if you look at their total loan portfolios. Is that not correct?

Mr. Bloom. That is correct.

Mr. Brown. What would be the capital-to-loan ratio of banks?

Mr. BLOOM. Capital to total loans?

Mr. BROWN. Yes.

Mr. BLOOM. It would be typically in the area of between 7 and 10 times capital. In other words, capital in a bank we felt comfortable with would be at a ratio of 8 to 1.

Of course, loans are only a portion of a bank's assets. They will also have significant amounts in bonds and investment securities—municipal bonds, Treasury bonds, and deposits of cash of other banks. So the ratio of a bank's total assets to its capital is going to be more in the area of 5 to 10 percent.

Mr. BROWN. So therefore, even when you get down to group D, which is defined as 80 percent and over, you are not looking at criticized loans to total assets to total loans.

Mr. BLOOM. No; not at all. I tried to emphasize that.

Mr. BROWN. You are looking only to those as they relate to capital.

Mr. BLOOM. Yes, sir.

Mr. BROWN. And capital, in the typical situation, amounts to one-eighth of the assets available for the offsetting of those criticized.

Mr. BLOOM. That is correct.

Mr. BROWN. So, in effect, when you talk about group D, you are not looking at the solvency of the bank, but only to the extent that it reflects a particular ratio that you have selected and which, as I tend to concur, becomes less and less meaningful as banking practices have progressed over the years.

Mr. BLOOM. Yes. And this distortion is probably increased by the sort of natural inclination to regard the criticized loan as a potential loss. This is not the case at all. As a matter of fact, the actual number of our criticized loans that result in losses to a bank is quite low. This reflects probably a great deal of conservatism on the part of our examiners. For instance, City Bank, in its 1974 annual report to shareholders, indicated that of all of the examiner's criticized loans, only between 2 and 3 percent of them actually resulted in losses or charge-offs to the bank. And that is taking a period of 3 or 4 years.

Mr. BROWN. I think you make a very valid statement on page 2 where you say the significance of classified asset ratios as a supervisory tool is greater during prosperous times than it is during periods of recession such as 1974 and 1975. Now, you say that because during prosperous times the potential for worse times is greater than when you are in a recession and coming out of a recession. Is that not correct?

Mr. BLOOM. Yes.

Mr. BROWN. Therefore, the chances of, in effect, regrouping when you have had a bad period are much better than when you have had a prosperous period and the potential is for a less prosperous period. Isn't that correct?

Mr. BLOOM. Yes. I also have a somewhat simpler idea in mind. That is that a banker who is up to 65 percent of capital in classified loans in good times may have something wrong with him as a banker or loan officer. But in tight times, that same percentage does not indicate that at all. Everybody is having trouble collecting on loans. So in terms of a reflection on the loan officer's capacity, obviously, you have to consider the economic climate.

Mr. BROWN. Is it true that, with the recent economic climate from a couple of years ago when there seemed to be no end to the improvement, practically every financial institution finds itself in a much worse financial condition than it was in previously? This was true especially in the real estate area.

Mr. BLOOM. If you just take this single ratio and the problem of loan classifications, that is true. However, in terms of overall soundness, that isn't so true. They are in better shape now than they have been in a long time.

Mr. BROWN. And that is why you keep going back to the ability to absorb losses and things of that nature.

Mr. BLOOM. Yes, sir.

Mr. BROWN. I have no further questions, Mr. Chairman.

Mr. ROSENTHAL. Mrs. Collins.

Mrs. COLLINS. The statement was made a minute ago that the First National City Bank and the Chase Manhattan Bank were on the problem list because they were helping New York City during its financial crisis. Do you have any documentary evidence to that effect?

Mr. BLOOM. Well, it is certainly a matter of public record, Mrs. Collins, that New York City banks have substantial amounts invested in New York City bonds.

Mr. BROWN. Is it not also true, if the gentleman will yield for a second, that it is a matter of public record that those investments have not been the greatest?

Mr. BLOOM. Unfortunately, it is. And although the percentages for any one bank are not alarming, they certainly have not helped the situation. These are among the substandard assets.

Mrs. COLLINS. Speaking of substandard assets brings me back again to this 2 DP/3 classification. On page 4 of your statement, you say that you maintain lists of banks falling in these groups. Would a ratio of 2 DP/3 fall in your lists?

Mr. BLOOM. Those are the lists that we previously maintained. In other words, a composite ratio is what I was referring to as groups 3 and 4 banks.

Mrs. COLLINS. Would banks with a ratio of 2 DP/3 be required to submit monthly reports regarding the progress they have made toward improving unsatisfactory areas of these banks, in accordance with what you said on page 8 of your statement?

Mr. BLOOM. In a great number of cases; yes. That, however, is something that is tailored to an individual bank rather than just to ratings. But in many cases we would require a bank in that category to make monthly or some other periodic reports.

Mrs. COLLINS. On page 10 of your report, you say that your experience has indicated that the threat of a cease-and-desist proceeding enables your office to handle the majority of bank problems and so forth. Since 1969, how many cease-and-desist orders have actually been issued by the Comptroller and for what purposes were they issued?

Mr. BLOOM. I don't have the number with me, but I can supply that for the record. The general purposes are going to be to achieve the elimination of the particular problem in a bank. This is very often loans that are over the legal lending limit to a single borrower or self-dealing loans of one kind or another.

The particular abuse or unsound practice that we are trying to correct is usually the reason.

[The information referred to was not submitted.]

Mrs. Collins. When you were discussing the attachment you have on here, I think you said something to the effect that you didn't have any information on this for 1975 because that was on a card file and that the card file did not show whether the bank was on the list or when it had been taken off. Now, if that is the case, can you tell me how you know whether a bank has or has not been taken off the list, and whether more supervision is needed or is not?

Mr. Bloom. I am sorry, Mrs. Collins; I probably was not very clear on that. What I was trying to explain is that we now are on a different basis for singling out banks for supervision. We are working on a much more sophisticated type of analysis. In the meantime, we are still following banks that are graded under the old system.

Mrs. Collins. So you do have the information for those that you would have had in 1975?

Mr. Bloom. I think we may be able to bring that list up to date.

Mrs. Collins. Would you do that for us?

Mr. Bloom. If it is possible, we will.

[The information referred to was not submitted.]

Mrs. Collins. Since the Federal Reserve guarantees payment to depositors of major financial institutions, are we not providing the major banks with the opportunity to make available loans in excess of their assets rather than providing guidelines on loan limitations?

Mr. Bloom. I believe you are referring to the insurance of the Federal Deposit Insurance Corporation rather than to the Federal Reserve—which is now $40,000 for depositor. I am not sure I understand the relationship between the deposit insurance and the question you put, Mrs. Collins. Could you perhaps clarify that for me?

Mrs. Collins. It seems to me that by guaranteeing loans for deposits that are going to be in banks, that if these deposits are made to loans which might become creditable risks, that the insurance deposit is actually financing bad loans. I think that this is not a good practice, and that this does not insure the solvency of a bank or the safety of the deposits.

Mr. Bloom. The quality of a bank's loans is going to depend upon the care and the skill of the bank's loan officers. The source of the funds that it lends, of course, does not affect those qualities. I would agree that since the Government is in effect subsidizing banks by guaranteeing their liabilities to this extent that it behooves us as regulators to make doubly sure that that quality of management is as good as we can possibly achieve in a free enterprise system. But I don't see any direct relationship between the fact that deposits are insured and loan quality. Loan quality depends upon the skill of management and the general economic conditions, of course, that the borrowers are subject to.

Mrs. Collins. Let me put it another way. We know that the taxpayers support the Federal Reserve by interest on the national debt, and we support the FDIC by interest payments on loans. The lenders of last commitment of the Federal Reserve and the depositors of FDIC underwrite the risks taken by these banks. If that is the case, are we not subsidizing these sorts of actions that we do not want?

Mr. Bloom. I would agree that the FDIC system insofar as it guarantees a great proportion of the liabilities of commercial banks is a subsidy. But the banks do pay a premium for that coverage. Those premiums are accumulated into a fund which is somewhere approaching $4 billion. However, the confidence of the public in FDIC insurance is not based on that fund. It is based on the fact that the U.S. Treasury under the law has a commitment to lend to the FDIC if they ever—knock wood—needed it or had used up their funds. So to the extent that the FDIC is a Government operation, there is an element of subsidy involved.

Mr. Rosenthal. Congressman Drinan.

Mr. Drinan. Thank you, Mr. Chairman.

Mr. Bloom, you have before you and we have released this morning the adjusted capital to total assets of the two banks in question—the First National City Bank and the Chase Manhattan Bank.

Let me just read them. In 1969, the First National City Bank was 0.109 and declined in 1971 to 0.062 and declined in 1973 to 0.058. The Chase Manhattan declined from 0.099 in 1969 to 0.069 in 1971 to 0.061 in 1973. This is in the public domain now. Can you tell us the meaning of this? Assuming that these figures are accurate and understanding that it is only one criteria, how do they compare to the figures for other national banks? What do they show about the practices and conditions of these two banks during these years, and what do these figures reveal about the competence or lack of competence of your agency in regulating these banks? In other words, what are we going to make of these two figures that are now in the public domain?

Mr. Bloom. I would say that the trend in these banks was similar to the trend in all other banks. This particular ratio has been declining due to a combination of factors.

Mr. Drinan. Are Chase Manhattan and First National City Bank better off than Franklin National Bank which had some trouble that we don't have to go into?

Mr. Bloom. I will say, Father Drinan, that Franklin's problem was not due to a lack of capital. If their ratios were up under the most conservative 8 to 1 or 7 to 1, they still would probably have had to have been placed in receivership.

Mr. Murphy. Might I pick up on that, Mr. Congressman? If you look at the Franklin National Bank ratios, you will see that those ratios also declined somewhat. I think the percentage of decline may even be less than the two banks you mentioned.

Mr. Drinan. That is rather astonishing, isn't it?

Mr. Murphy. But had that ratio remained the same, at 0.077 in 1969, until the very end, that would not have saved that bank.

Mr. Drinan. I recognize that that is only one criterion. I have a slight interest in the First National Bank in Boston. For many, many years I have been told, "You have a friend at the First." How do they shape up in comparison to the two banks that a newspaper said were on the problem list?

Mr. Bloom. I am afraid, Father Drinan, that we cannot go into that.

Mr. Drinan. I am trying to get indirectly what you have refused to give us directly. But can you give us some estimate of what this list means? This is in the public domain now, sir. And if you want to prevent the failure or the decline of confidence on the part of depositors, you have to tell the public what this means.

Mr. BLOOM. I would tell the public to attach very little significance to this ratio because standing alone it is virtually meaningless.

Mr. DRINAN. Has anything happened to the First National City Bank and the Chase Manhattan Bank since the newspaper story?

Mr. BLOOM. I don't know. That is very hard to estimate.

Mr. DRINAN. Have they complained?

Mr. BLOOM. Yes; they have complained.

Mr. DRINAN. And you have been in communication with the top officials of those two banks, I suppose?

Mr. BLOOM. We have heard from them, yes, sir.

Mr. DRINAN. That is what I mean. And what do they say about these alleged revelations?

Mr. BLOOM. I don't know that I have discussed that with them. We haven't been in daily communication. But I would say, Father Drinan, that if Jim Smith hadn't delayed his departure and, along with the rest of us, worked mightily on the Sunday that these stories appeared to get balancing stories in some of the same editions of the newspapers, I think that the effect on these two banks might have been much more damaging than it was.

Mr. DRINAN. I read the so-called balancing stories. They were sort of short on facts. I have all of the articles here.

We have a tough job here, sir. We are not trying to embarrass anybody, but we, under the Constitution, are elected by the people out there to conduct oversight on the agency where you give your distinguished service. And we are just trying to restore public confidence as the facts merit it. We are just trying to get at the facts.

We, as a subcommittee of this vast Congress, are trying to get to whatever meaningful facts we have about these two banks or other banks. And it is rather astonishing that from 1969 to the present, as detailed in your annual report here, the number of banks with deposits of over $1 million with more than 50 percent of their total loans listed as classified has increased sharply. It has gone up from 11 in 1969 to 30 in 1971 to 46 in 1974. What does that trend mean?

Mr. BLOOM. Fifty percent of their total loans?

Mr. DRINAN. I have it here, sir. I telescoped that. This is in table 38 on page 246 of the annual report. So just tell me what the trend means. The trend has been going up, has it not?

This is a very common way of evaluating banks, as is the capital to the asset ratio. That is what is on this list here. As this figure falls, it would seem to the layman that the banks are becoming increasingly vulnerable to some type of danger. And since the late sixties, the capital asset ratio of the Nation's largest banks has dropped dramatically.

I will put it into round figures, if you want it another way. Net loan losses in 1969 were $303 million; in 1970, the figure doubled. It went from $303 million to $601 million. And last year, in 1974, the losses were up to $1,193 million. It is true that you can say that inflation and recession come into it, but the ordinary depositor reading that, including myself, would ask if this is due to increased speculation by the banks and whether the three or four regulatory agencies should be doing something about this increased speculation.

Mr. BLOOM. We do not have any evidence that it is due to increased speculation, Father Drinan.

Mr. DRINAN. Wasn't that speculation increased and sanctified by the Bank Holding Act of 1970?

Mr. BLOOM. I don't know that it was.

Mr. DRINAN. What is it due to then? Why do the large banks in 1974 have net loan losses of $1,193 million?

Mr. BLOOM. Because of the recession, Father Drinan. In tight times, borrowers go bankrupt and you lose money on loans.

Mr. DRINAN. If you want that answer to be accepted by us and if you want that to be plausible to the public, you have to demonstrate that they had these losses as a result of loans made way back in the good days which now have gone sour. And as I read the evidence, that is not demonstrable. They went into loans that were high risks. They were in condominiums and other things. Then when the depression came, it was clear retroactively that maybe they had been too speculative and too risky.

Mr. BLOOM. The business of commercial banks is to take risks. Sure, we could nail down a banking system so that you never had more than a 50-percent ratio. We could have a banking system where you never had a bank failure. But you wouldn't have much of an economy if you had bankers that wouldn't take any risks. That is the business of commercial banks.

Mr. DRINAN. We all agree on that. But I am just trying to get some facts. My job, as defined by the Constitution, is to supervise the executive branch of the Government. That is a complicated thing. But I go back to the time when there was no depression—way back in the Nixon era when we had "full prosperity"—in 1969 and 1970. Why, at that time did the figure for loan losses double in 1 year from $303 million to $601 million?

Mr. BLOOM. The recession of 1969 probably accounted for a great deal of that.

Mr. DRINAN. I would like to come to another point about secrecy and about what you said in your statement here. I understand that you people have a sensitive job and all, but I fail to see the logic in what you state on pages 10 and 11 when you say: ". . . we will be hampered considerably in obtaining a complete picture of national banks" if the rules are changed. You are practically threatening us.

> If the rules are changed to require public disclosure of what is in the examination report, there is no doubt that we will be hampered considerably in obtaining a complete picture of national banks.

And then you go on to say that if you, dear Congressmen, require disclosure of these things, then you are going to make correction of the problem incomparably more difficult, if not impossible, in some cases.

My mind goes to the opposite conclusion. I think that every corporation should be required to have disclosure. As a matter of fact, the very statute that was quoted here suggests to me that Congress so intended. And that statute said that after 90 days and another period of 30 or 60 days when the bank is warned that disclosure is forthcoming, then that information should be made public. Why do you shrink back from sunshine?

Mr. BLOOM. Mr. Congressman, I don't shrink back from sunshine. My point is that if you had a report which was a public report it would be a different report. That is all I am trying to say. The report that you get by an examiner's talking to a banker in confidence and the report that you will get by an examiner's talking to a banker on the record is going to be a different report. In my opinion, the total efficiency of regulation will be lowered, not increased.

At the present time, the bank examiner, unlike any other Federal agency official that I know of, will walk into a bank and the banker will let him roam around that bank and let him look at anything he wants without the bank's counsel at his elbow. If an IRS agent walks in or if a Federal Trade Commission agent walks in or if an SEC agent walks in, the first thing the businessman is going to do is call his lawyer. And the whole thing is a very arm's-length operation.

Bank examination by tradition, but for good and sufficient reasons I believe, has evolved in a completely different direction.

Mr. DRINAN. But it is merely by tradition. And we are examining, sir, that tradition.

Mr. BLOOM. You should examine it. But I would say that before you discard it, you had better take a look at some of its advantages. It has the advantage of providing the Government with a picture three times every 2 years of what is going on inside a bank. You will never get this by any public disclosure system.

I am not saying that banks should not disclose. They should. And they do—almost all of the financial numbers in the bank. But when you are talking about this personal interrelationship between bank examiners and bankers, you are talking about something else. You are talking about a subjective process basically. And it will change if it is public.

The bank examiner isn't going to say the same thing for public distribution that he says for the Comptroller's eyes only. I am not saying that it couldn't work that way, but it will not be the same system. So you are not just talking about disclosure of reports; you are talking about changing a system which has worked, I think, as well or better than any other system of Federal regulation.

Mr. DRINAN. Sir, let's get back to the point for which the meeting was called. What should this committee do about the statements in the press concerning the two banks? I have two letters from constituents. How should I answer them?

Mr. BLOOM. We have received similar letters. The way we answered them is to state that the system as a whole is in good shape and that they have nothing to fear about the soundness of the national banking system.

Mr. DRINAN. I am not going to tell my constituents not to have fears and I am not going to tell them not to take their money out of Chase Manhattan unless you come up with some facts, sir.

Mr. MURPHY. Might I say a word on that, please, Mr. Congressman? You asked a few minutes ago about what had been the effect on those two banks. If I understand it correctly, the certificate of deposit market and the stock market in the shares of the two holding companies that own those banks have shown practically no reaction. There is a reason for that. That is that most of the information that was in the Washington Post story already had been disclosed through the call reports and through the report of those two corporations filed with the Securities and Exchange Commission. That information already had been evaluated by bank stock analysts who recommend investments and by other banks who were in one way or another investing money, through Federal funds or otherwise, in these two major banks. So there was a disclosure already. All that was disclosed in the Washington Post story was some textual evaluation of what our examiner thought. And many people evaluating the public figures had reached the same conclusion.

Mr. DRINAN. It just might be that the depositors who are lucky enough to have money in the Chase Manhattan just don't read the Washington Post.

My time has expired.

Mr. ROSENTHAL. I am one who does though. For the record, I have been a depositor in the Chase Manhattan for 20 years and they are a pretty nice bank. I haven't taken my $200 out. Congressman Levitas.

Mr. LEVITAS. Thank you, Mr. Chairman.

I am, Mr. Bloom, very sensitive to the careful approach which this committee must take in dealing with the very serious charge that it has in evaluating the effectiveness of the banking regulatory system, and that in pursuing our duty that we not undermine public confidence, but rather that we do those things which are necessary to maintain, and if need be, to restore public confidence. In this regard, we are obviously not investigating the Chase Manhattan Bank or the First National City Bank. We are really trying to find out the effectiveness of the existing regulatory and supervisory system.

I am very cognizant of that. And I hope that as this committee proceeds in these investigations that we will be mindful of that and take necessary steps to assure that improper revelations are not made of information which we obtain.

However, I fail to see how we can discharge our responsibility in evaluating the effectiveness of the regulatory agencies without having the information to do so. I see a great deal of difference between publication, for example, in public, open sessions of bank examination information and the consideration of that information in order to evaluate whether your department or the Federal Reserve is doing its job.

You would agree, I am sure, that this committee has the responsibility of assessing the effectiveness of the bank examining procedures and the regulatory operations of the Comptroller. You would agree with that, wouldn't you?

Mr. BLOOM. I am told that the jurisdiction of the committee is to exercise oversight functions over every Government agency.

Mr. LEVITAS. You would agree with my statement that this committee has the responsibility for evaluating the effectiveness of the bank examining and regulatory systems such as that of the Comptroller.

Mr. BLOOM. Yes, sir.

Mr. LEVITAS. There seems to be a Catch 22, however. You don't think that we ought to have the information of the bank examination reports to ascertain whether that is being done or not. Is that also correct?

Mr. BLOOM. I am not sure, Congressman, whether we have an indication from the committee as such that they wish this information.

Mr. LEVITAS. Leaving aside whether or not we have actually taken the necessary steps, as I read your statement on pages 10 and 11, you question whether we ought to have that information—as a matter of policy and regardless of whether or not we have gone through the necessary steps.

Mr. BLOOM. I wouldn't put it that way, Mr. Levitas. I would say that there are problems of unauthorized leaks and that sort of thing involved in the process of disclosing to the Congress. That is not a new problem and it is not at all unique to our agency or to this committee. But that problem does exist. And the subjective parts of our reports are sensitive.

Mr. LEVITAS. Let me go to the point that you and Congressman Drinan were discussing at the end and to the point to which your counsel alluded. You were talking about availability of public information.

On page 11, you say: "The confidentiality of Government examinations, however, does not impair the public's right to obtain necessary financial information about banks." And you refer to the availability of reports filed with the Securities and Exchange Commission. Do you think those reports are entirely sufficient to provide a depositor with information as to the potential safety of his deposits in a bank?

Mr. BLOOM. Those reports as they are evolving and being supplemented by the SEC are very comprehensive.

Mr. LEVITAS. I don' think you have answered my question. Do you think they are sufficient?

Mr. BLOOM. I think they are sufficient to enable a large depositor—after all, it is the depositor who has funds of over $40,000 who is at risk as far as the bank's management is concerned.

Mr. LEVITAS. If you think they are sufficient, then why does the Comptroller of the Currency require other information and other data that is not contained in the public reports? If you feel that it is absolutely sufficient to determine safety, why do you in your examinations go beyond that information? Obviously you think it is not sufficient.

Mr. BLOOM. There are two answers to that. I think our charge is probably greater than that of an individual depositor. But second, the SEC laws do not cover all of our banks. It only covers those banks that are publicly owned; that is, that have more than 500 shareholders. The great majority of our banks have less than 500 shareholders and are not subject to those particular disclosure requirements.

Mr. LEVITAS. Mr. Bloom, is it not true that you as the deputy know that the reason that the procedures and the information sought by the Comptroller General is far beyond that required on the public reporting to the SEC is because that information is essential for you to determine the safety and security of deposits in those banks, and which is presumably what the public is interested in if they want to make their deposits?

Mr. BLOOM. I generally agree with that, of course. But the information we have is so detailed that it couldn't possibly be of use or even feasible to publish. Our report is pages and pages of analysis of bank borrowers—the companies that borrow from banks. This is what the statute says should not be disclosed under penalty of fine or of imprisonment. That is information not about the bank, but about the bank's assets which are loans. In other words, it is the financial condition and everything else about the borrowers of the bank. That is the bulk of our report. You couldn't publish that without affecting hundreds and hundreds of people in a community and their right to privacy.

Mr. LEVITAS. I am not talking about publication. We are talking about making this information available to us in an executive session to evaluate whether or not the procedures you are following are adequate.

Mr. BLOOM. I certainly do not challenge or disagree with the committee's need to have what it takes to properly oversee our functions. I do say there are countervailing interests of privacy that we have to consider in this particular document.

Mr. LEVITAS. Let me go on to your statement. There are one or two points I would like to clarify. On page 1 of your statement, in the last paragraph on the page, you have two statements which, as I read them, appear to be contradictory. I will read them to you. The first sentence is: "There is no magic formula or ratio which is capable of identifying banks for special supervision with any degree of accuracy." That is the first statement.

That is immediately followed by: "As a practical matter, however, we have used in the past a quantitative formula based on examination report data which identify those banks to be given further analysis at all staff levels." And then you proceed to quantify these various approaches and come up with symbols like 2 DP/3.

It seems to me that while you say there is no magic formula or ratio, you in fact use a magic formula or ratio.

Mr. BLOOM. We use what tools there are. This is a rough rule of thumb which gives us a list which we further attempt to refine by looking at each bank on a case-by-case basis. But there is no easy way of doing this.

Mr. LEVITAS. On page 2, Mr. Bloom, of your statement, you talk about a ratio of 65 percent or more of classified assets in a prosperous economy could be reflective of poor management. A ratio of 65 percent or more during 1975 and at present does not necessarily reflect adversely on management. Now is the reflection on management the same thing as the safety of the deposit or is it a judgment as to the quality of the management itself, whereas the safety of deposit may depend upon other factors such as losses or substandard loans or loans which have been classified for reasons beyond the quality of management?

In other words, is quality of management the sole criterion as to safety?

Mr. BLOOM. No; but it is a very important factor.

Mr. LEVITAS. But there are others. So you would not limit a good judgment as to management as to the safety of deposits or the soundness of a bank?

Mr. BLOOM. No.

Mr. LEVITAS. In your testimony, you made some very favorable references to City Bank's profit picture and the strength of their assets. Do you feel that other banks should have portfolios with the same degree of risk as First National City Bank?

Mr. BLOOM. No; of course not.

Mr. LEVITAS. Then I don't understand why you were using that as an example of how well they are operating and how well they have been managed if you would not recommend that as a model to be followed by other institutions.

Mr. BLOOM. My point was that their high ratio of problem loans was caused by factors other than poor management.

Mr. LEVITAS. Let me go to another question as far as your procedures are concerned. This was not covered in your earlier testimony. It ties back into some earlier hearings that this committee had on the question of New York City bonds. I would like to know how much dependency the Comptroller places on third-party evaluations and judgments. When we had hearings earlier, it came out that in determining whether the municipal bonds which banks held, particularly New York City, should be classified as good investments or not that the Comptroller was relying exclusively on information furnished by Standard and Poor's and, I believe, Best and perhaps some other services. No independent evaluation was made by the Comptroller of the Currency, although charged with this responsibility, to determine the soundness of those assets. Is that the case?

Mr. BLOOM. No; not exactly. A great deal of reliance has been placed by our examiners on those bond rating agencies. I would not deny that.

Mr. LEVITAS. Do you feel that this is an abandonment of your responsibility to a profitmaking, outside, private sector operation rather than the performance of responsibilities that should be performed in the public interest by the Comptroller?

Mr. BLOOM. No; I think we should develop more internal capacity in this regard, but it is an extremely complex undertaking. The rating of municipalities would involve some difficult political issues as well as just plain manpower and expense items. In other words, to set up, in effect, our own rating system for every municipality in the country would be a tremendous undertaking. So it would have been foolish of us not to utilize the very extensive commercial rating services that were available. And we use them because they are there.

Mr. LEVITAS. I suggest, Mr. Bloom, based on what I have heard up to this point that you do not just use them, but that you rely upon them almost exclusively.

My last question is in the same area. Other than the Comptroller's apparent dependency and almost total reliance upon the private sector rating bureaus for municipal bonds, are there any other areas of examination or evaluation where the Comptroller does not use its own resources but relies upon the evaluations of basically private sector third parties to make judgments as to the soundness of assets, such as real estate appraisers or the like?

Mr. BLOOM. I don't think so. You have pinpointed the one area where we have relied rather heavily on outside evaluations, but I don't know of any other.

My colleagues have correctly reminded me of the fact that when we examine the credit file of a bank on a real estate loan, one of the things we insist on is an up-to-date appraisal of the property. We don't undertake to appraise real estate ourselves. So this would be an outside appraisal which we require the bank to have. In that sense, we are relying on it, I suppose.

Mr. LEVITAS. But you have no system of evaluating the accuracy of those real estate appraisals on a spot-check basis or some other procedure?

Mr. HOMAN. They are usually MAI appraisals. That is an independent appraisal service consisting of a professional organization.

Mr. LEVITAS. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Congressman Moffett.

Mr. MOFFETT. Thank you, Mr. Chairman.

Mr. Bloom, you have given testimony with regard to the trends in the ratio of adjusted capital to total assets and what you feel that means. I wonder if I might ask you to comment on some other ratios and the trends of each of those ratios since 1969 among the 50 largest banks under your jurisdiction. No. 1, the ratio of earnings before taxes and security losses to average total assets.

Mr. BLOOM. I am afraid that we will have to ask to submit some paragraphs or an essay on what we consider the significance of that particular number for the record.

Mr. MOFFETT. Would you do that?

Mr. BLOOM. We would be glad to.

Mr. MOFFETT. Would your answer be the same in terms of ratio of net income to average total assets?

Mr. BLOOM. Yes, sir.

[The information referred to was not submitted.]

Mr. MOFFETT. By the way, how is the average determined?

Mr. HOMAN. The average is determined by an average of the four call report dates taken over the year. That is every quarter.

Mr. MOFFETT. What about what is called the invested asset ratio? As I understand it, it is the ratio of highly liquid assets.

Mr. HOMAN. That is not one of our formulas that we use. We have a separate liquidity which I will be glad to send you.

Mr. MOFFETT. Would you be able to comment on that ratio, however, with regard to the trend of that ratio since 1969?

Mr. HOMAN. I don't have the trend information with me. It generally measures the liquid assets of the bank.

Mr. MOFFETT. Would you provide that?

[The information referred to was not submitted.]

Mr. MOFFETT. And how about ratio of net loan losses to equity capital plus reserves?

Mr. BLOOM. That is, in effect, what we have spent a great deal of the morning talking about, I think.

Mr. MOFFETT. Have you commented on trends since 1969?

Mr. HOMAN. I think Mr. Bloom already gave the committee figures with respect to the earnings of the bank and how they relate to the increases in loan losses. There is no doubt that loan losses have increased, but earnings have increased at a faster pace.

Mr. MOFFETT. Thank you. Now with regard to what is called the capital account, could you explain the components of that?

Mr. HOMAN. Yes. There is equity capital which includes capital stock of the bank, surplus, and undivided profits. We use the term "gross capital funds" which added to equity capital would include reserve for loan losses and capital notes of the bank subordinated to the interest of depositors.

Mr. MOFFETT. Does the Comptroller include long-term debts in the definition of capital?

Mr. BLOOM. Only if it is subordinated debt. In other words, subordinated to the claims of depositors—so-called capital debt.

Mr. MOFFETT. From a business standpoint, does long-term debt absorb losses?

Mr. HOMAN. No.

Mr. MOFFETT. Then if it is not available to absorb losses, is there any reason to include it in the capital account?

Mr. BLOOM. In the liquidation sense; yes. In other words, at a point of liquidation, it would be a cushion for the protection of depositors because it could be used prior to the payment of the subordinated debt. You are correct in a going concern sense in that it is not available for loan chargeoffs or undivided profits.

Mr. MOFFETT. Mr. Bloom, in conclusion of my time, I wonder if I might ask you a couple of questions about the philosophy of bank regulation. It is my understanding from your testimony that you do not believe that regulators have a responsibility to save all banks. Is that correct?

Mr. BLOOM. Yes.

Mr. MOFFETT. Would you agree that disclosure of the condition of a bank can foster competition?

Mr. BLOOM. I would put it somewhat differently. I would say that the more that the public knows about all banks on a comparative basis, with everybody reporting or disclosing on the same volume and the same basis—and not the unfortunate thing we had last week of one or two being picked out for disclosure when everybody else isn't—but I would say on that uniform basis that the more the public, the consumer, knows about competing institutions, the more effective the choice and the competition could be. I would tend to agree with that.

Mr. MOFFETT. More competition would probably mean more failures as well. Is that right?

Mr. BLOOM. Or more mergers.

Mr. MOFFETT. Would the survivors be more fit?

Mr. BLOOM. They likely would—and probably a lot larger too.

Mr. MOFFETT. I just wonder what the role of the bank regulator should be and I certainly don't have an answer. I am just probing here to try to elicit your opinions. I wonder if we might not give some consideration to regulators being information gathering agencies which report findings but don't set strict minimum capital asset ratios, for example.

On the other hand, with regard to banks like Chase, it is obvious to me that they are too big for us to allow them to fail. Isn't that correct?

Mr. BLOOM. The consequences would be tremendous. There is no question about that.

Mr. MOFFETT. As I recall, Arthur Burns made a statement in Hawaii before the American Bankers Association. There was a great deal of hubbub over it and there were predictions that it would cause the public to worry and that it would cause damaging consequences. That really didn't happen though, did it?

Mr. BLOOM. Mr. Burns himself on Sunday on "Issues and Answers" characterized the results of his speech as very positive. The banks, to paraphrase his words, heeded his advice and improved their performance considerably since then.

Mr. MOFFETT. I just wonder about the psychological impact of many of these things and whether they are really as great as some say they will be—including the Post article. Do you really think it is significant?

Mr. BLOOM. I think that the haphazard and sporadic nature of this type of publicity of pinpointing this bank or that bank for accidental reasons tends to confuse the people more than enlighten the public.

Mr. MOFFETT. Thank you, gentlemen.

Mr. LEVITAS. Mr. Chairman.

Mr. ROSENTHAL. Mr. Levitas.

Mr. LEVITAS. For the reasons that I stated earlier during my time, I now would like to offer a motion as follows: I move that the Subcommittee on Commerce, Consumer, and Monetary Affairs recommend that a subpena be issued by the full Committee on Government Operations ordering the production by the Comptroller of the Currency of the examination reports of Chase Manhattan Bank and First National City Bank of New York for the years 1969 through 1975, together with other relevant material in the possession of the Office of the Comptroller, and that these documents be produced and returned to a closed executive session of the subcommittee in accordance with House Rule XI(g)(2).

Mr. ROSENTHAL. In view of the seriousness of this motion, we will have the clerk call the roll.

The CLERK. Mr. Rosenthal.

Mr. ROSENTHAL. Aye.

The CLERK. Mrs. Collins.

Mrs. COLLINS. Aye.

The CLERK. Mr. Drinan.

Mr. DRINAN. Aye.

The CLERK. Mr. Levitas.

Mr. LEVITAS. Aye.

The CLERK. Mr. Evans.

Mr. EVANS. [No response.]

The CLERK. Mr. Moffett.

Mr. MOFFETT. Aye.

The CLERK. Mr. Maguire.

Mr. MAGUIRE. Aye.

The CLERK. Mr. Mezvinsky.

Mr. MEZVINSKY. [No response.]

The CLERK. Mr. Brown.

Mr. BROWN. No.

Mr. ROSENTHAL. The motion is agreed to and we will act accordingly. Mr. Maguire.

Mr. BROWN. Mr. Chairman, I would just like to make a comment. I think it a little unusual that we had a motion of this nature before we completed the hearing. Had we had a chance to discuss the results of this hearing after it was completed and if we then concluded that we didn't receive enough information and were not going to have it furnished without a subpena, then my vote might have been different. I think that normally we conduct hearings and then after they have terminated, we decide what further action to take.

It was the timing of the motion rather than its substance that caused concern. My prime reason for voting against it at this time was the timing rather than the substance.

Mr. ROSENTHAL. The vote is recorded at 6 to 1. Mr. Maguire.

Mr. MAGUIRE. Thank you, Mr. Chairman.

Mr. Bloom, what steps, if any, would the Federal Government take to prevent a huge bank from failing in the event that a catastrophe of that sort were likely to occur? You have talked a lot in your statement about consultation and reports and so on, and cease and desist as a rehabilitative measure. But let's assume, just for the sake of argument, that Chase and First National City Bank or any bank which is in a group 4 situation, in your own words, approaching insolvency, requires fairly drastic action. What would you do if it were your judgment that the situation was in fact terribly serious?

Mr. BLOOM. It would depend on what the nature of the seriousness of the problem is. Without knowing whether you had an asset problem or a liquidity problem or a management problem, it is hard to answer.

Mr. MAGUIRE. Let's just take all three. Presumably some of these things happen in combination, but what would you do with each one separately?

Mr. BLOOM. For management, we would move heaven and Earth to get better management in there.

Mr. MAGUIRE. If it were liquidity?

Mr. BLOOM. The Federal Reserve in a case of that nature would, I am sure, use herculean effort to supply liquidity.

Mr. MAGUIRE. And for the third one?

Mr. BLOOM. The third was the asset problem. That, in and of itself, can be carried as long as you have public confidence and the bank is meeting its obligations. You can work with an asset problem. Basically, you would explore methods of getting additional capital into the bank.

Mr. MAGUIRE. So the use of the words "approaching insolvency" do not necessarily determine or characterize fully the situation, in your judgment, of a group 4 bank?

Mr. BLOOM. There are two kinds of insolvency. There is asset insolvency where a bank's assets have lost worth to the extent that their liabilities completely have used up the capital of the bank. And then there is the more common trigger for insolvency, which is liquidity. In other words, that is the bank's inability to sell assets quickly enough to meet obligations as they are made upon it.

Mr. MAGUIRE. Just to go a little further with this, what is the difference between the issuance of a letter of credit and the making of a loan by a bank? Is a letter of credit considered an asset of the issuing bank?

Mr. BLOOM. There are several types of letters of credit. The traditional type is similar to a commitment by a bank to lend up to *x* dollars to a borrower or to make *x* dollars of credit available to a borrower. Until the borrower takes advantage of that line, it is not an asset. When the borrower does take advantage of it and the bank extends the credit, it becomes an asset.

Mr. MAGUIRE. And there are other types of letters of credit that would be calculated differently?

Mr. BLOOM. There is another type which is called a standby letter of credit. It, in effect, is an agreement by the bank to take up an obligation of the bank's customer to a third party in the event the bank's customer fails for some reason or other to pay the third party. The standby letter of credit obligates the bank to take up that.

Mr. Maguire. Prior to the time that that obligation would have to be fulfilled, let's say, does that appear on the asset ledger or not?

Mr. Bloom. No.

Mr. Homan. It appears as a contingent liability of the bank. These are fully reported.

Mr. Maguire. But in a separate category?

Mr. Homan. Yes.

Mr. Maguire. Do you have any idea what the dollar amount of letters of credit of either or both types that you have mentioned which have been issued and are outstanding by national banks?

Mr. Bloom. We don't have it with us, Mr. Maguire, but I think we can probably supply that information.

Mr. Maguire. I wonder if you would be so good as to supply the subcommittee with that information—the aggregate amount of funds committed by letters of credit to, let's say, the airline industry and foreign countries by the 20 largest national banks? Would that be possible?

Mr. Bloom. Mr. Maguire, are you just referring to letters of credit, or are you also referring to commitments to lend?

Mr. Maguire. I am referring to letters of credit of the two types that you mentioned. What other kinds of commitments to lend should we be talking about?

Mr. Bloom. There are other types of commitments to lend. A letter of credit is just a particular type of instrument. But when you refer to airlines and other industry, it sounds to me as if you are talking about commitments to lend rather than letters of credit.

Mr. Maguire. Perhaps you had better review briefly what kinds of additional commitments to lend there are and how they are described. Presumably the same logic applies here in that they are commitments which potentially would have to be met, but which do not appear as assets until such time as some contingencies actually take place. Is that correct? But what would be the types of commitments?

Mr. Bloom. We will try and develop that information for you. However, it is a little difficult because there are various types of commitment and there are various gradations as to how binding the commitment is.

Mr. Maguire. All of this certainly figures, does it not, in an assessment of a bank's capabilities and status?

Mr. Bloom. It surely does. And we keep very close track of it.

Mr. Maguire. Mr. Chairman, with your permission, perhaps I could rephrase the question to include all of these types of commitments. Would that be appropriate?

Mr. Rosenthal. It is perfectly appropriate.

Mr. Maguire. And some assessment of the aggregate with regard, for example, to the airlines or foreign countries.

Could we ask for that by February 20? Would that be acceptable?

Mr. Bloom. To the extent we have that information, we will be glad to supply it.

Mr. Maguire. Presumably you do have it because you just said it was a very important matter that you paid close attention to.

Mr. BLOOM. I don't know whether we have it broken down exactly the way you have indicated—but we have information.

Mr. MAGUIRE. You have it by bank, presumably, don't you?

Mr. BLOOM. Yes.

Mr. MAGUIRE. Then you can add up the 20 largest and have an aggregate.

Mr. BLOOM. But whether we have it by industry is something else.

Mr. MAGUIRE. I see. Why don't you give us the best that you can on that.

[The information referred to was not submitted.]

Mr. MAGUIRE. Do you have any idea to what extent letters of credit may have figured into the enormous indebtedness of the real estate investment trusts to regional banks?

Mr. BLOOM. I don't know of any use of letters of credit by real estate investment trusts.

Mr. MAGUIRE. Let's go back to my opening question.

I have just been advised, Mr. Bloom, that letters of credit did come into play with regard to the REIT's in backing up the commercial paper when that got into trouble, and that Mr. Burns had, in his famous letter to the banks on that subject, encouraged the extending of additional credit lines in order to shore up the situation. That is also my recollection from reading the financial pages at the time. Is that not the case?

Mr. BLOOM. It could be. I think we may have a difference of nomenclature. I would refer to that type of credit as a backup line. In other words, the bank had a backup line with the REIT.

Mr. MAGUIRE. I think it might be useful if we got all of the categories out on the table. It is like Pandora's box. Every time we turn around, there is an additional phrase for some additional extension of the banks.

Mr. BLOOM. It is a very complex subject.

Mr. MAGUIRE. Let's go back to my initial question when I asked you what steps you would take to prevent these banks from actually failing if it appeared that they were going to do so. I take it that you were saying steps would be taken, in fact, to prevent a huge bank from failing.

Mr. BLOOM. I would assume so; yes.

Mr. MAGUIRE. Isn't one conclusion that one would draw from that, that it effectively guarantees that bank's solvency, in a sense?

Mr. BLOOM. Hardly.

Mr. MAGUIRE. Doesn't it give them an advantage over their smaller competitors?

Mr. BLOOM. Hardly. I don't think the stockholders of the U.S. National or the Franklin or even the Security National feel that solvency of those banks was protected. You must draw a distinction between protecting depositors and protecting the solvency of institutions. Solvency has been protected only insofar as the creditors were concerned, but not insofar as the owners of the institution—and who suffered mightly in all of those institutions.

Mr. MAGUIRE. But you don't think that the two interrelate to the point of giving one group of competitors an advantage over another?

Mr. BLOOM. I am not sure I understand your point.

Mr. MAGUIRE. If the large banks know that steps are going to be taken to protect them from going under, won't they have an advantage? Apart from the creditors, you wouldn't want the big banks to collapse, would you?

Mr. BLOOM. It depends what you mean by "collapse." In the Security National case or the Franklin case, no depositor suffered any loss. But those banks collapsed. There is no question about that. And those were not small banks. There are many ways of protecting depositors without propping up a bank as a corporation. As a matter of fact, I don't know of any case where the Government has done that.

Mr. MAGUIRE. But you wouldn't limit your interest in the major banks to just depositors, would you?

Mr. BLOOM. Yes, we would.

Mr. MAGUIRE. You would?

Mr. BLOOM. We would—our charge is depositors.

Mr. MAGUIRE. So then maybe this is an explanation for your relatively relaxed attitude toward the adjusted capital total assets ratio that we have been looking at. You can pick up the depositors later even after the big banks fail. Is that a possible interpretation of your comment?

Mr. BLOOM. If you are saying that our primary concern is depositors and not shareholders, you are correct.

Mr. MAGUIRE. What banks have switched to national bank status since 1969, Mr. Bloom?

Mr. BLOOM. I don't have it with me, but I can supply it for the record.

[The information referred to was not submitted.]

Mr. MAGUIRE. Presumably the First National Pennsylvania Bank was one of them?

Mr. BLOOM. Yes, sir.

Mr. MAGUIRE. Do you know why that bank switched?

Mr. BLOOM. No, I don't.

Mr. MAGUIRE. Was the bank below the Federal Reserve's acceptable level of adjusted capital to assets ratio when they switched?

Mr. BLOOM. I don't know the answer to that.

Mr. MAGUIRE. Were they below the Comptroller's acceptable level of adjusted capital to assets ratio?

Mr. BLOOM. I don't know. As I have been saying all morning, this is not a fixed number. The ratio is a flexible thing.

Mr. MAGUIRE. So you don't know whether they are now below whatever your flexible number would be in this case?

Mr. HOMAN. We don't have a flexible number in that respect. We don't have a ratio below which we would consider inappropriate.

Mr. MAGUIRE. What about zero?

Mr. HOMAN. Again, we would take into consideration all of the banking factors in appraising a bank.

Mr. MAGUIRE. What about the 65-percent guideline that you testified to earlier?

Mr. HOMAN. That is a trigger mechanism only to identify banks for further analysis. After that, we determine the level of supervisory attention that the bank requires.

Mr. MAGUIRE. So in other words, you can get triggered, but still the judgments can be made that it really doesn't matter that much because in the particular circumstances of a given bank that in fact is not a measuring stick that makes any sense?

Mr. HOMAN. Professional analysis makes judgments based on all relevant factors, not one particular ratio.

Mr. MAGUIRE. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Mr. Brown.

Mr. BROWN. Mr. Bloom, we have made much of this group A, B, C, and D. And you have said in your statement that banks are graded in four groupings according to the ratio of assets classified as loss, doubtful or substandard, to gross capital funds. And then you have a group of 80 percent or more. And 80 percent or more of gross capital funds equals what ratio to those assets?

Now you have said that gross assets basically is 7 or 8 to 1. Let's say 8 to 1. That means that you are talking about 80 percent of one-eighth, are you not?

So in effect, anybody in group D still only has 10 percent in all three categories, including doubtful or substandard. That still only leaves 10 percent of the capital assets of that bank. Is that right?

Mr. HOMAN. Yes. If you have a bank with capital to total assets of say 5 percent and your classified assets equaled 100 percent of the capital, then your ratio of classified assets to total loans would fall in the neighborhood of 6 or 7 percent of the total loan.

Mr. BROWN. Then you would have to reduce that somewhat from the standpoint that not all of those loans are going to go bad, wouldn't you?

Mr. HOMAN. That is correct.

Mr. BROWN. Some are only substandard.

Mr. HOMAN. Most of our classifications indeed do fall into the substandard category and the examiner, in that category, has stated that they are slow but that there is no loss potential in them at that point.

Mr. BROWN. I think these things need to be brought out. I think there is a total misconception of what these ratios mean insofar as their potential for loss is compared with the solvency of the ongoing operation of the institution.

Mr. HOMAN. That is correct.

Mr. BROWN. That makes it very important. Thank you.

Mr. ROSENTHAL. Mr. Drinan.

Mr. DRINAN. Mr. Bloom, since we don't have the essential data to make some judgments, would you try to explain what James Smith, the Comptroller of the Currency, meant when he said in a statement in the New York Times on January 12 that the loan losses in this Nation's largest banks for the years 1974 and 1975 have been above historic norms. Does that mean that they have been above the 1930's?

Mr. BLOOM. In dollar terms; yes. The system, of course, was a lot smaller in the thirties than it is today.

Mr. DRINAN. I conclude from what the Comptroller said that the loan losses in this Nation's largest banks for 1974 and 1975 were unprecedented. We have never ever had such disastrous loans which have been written off. That is what I gather.

So he is seeking to refute what the Washington Post has said. He concluded that this is well known.

He then comes to Chase Manhattan and the First National City Bank and says that these two banks continue to make money.

The naked fact is that they make money to offset these loans by increasing the interest that is charged on mortgages and loans or by lowering the interest rates that are given to depositors.

Why is it so wonderful that they have earnings? They just manipulate the interest rate. That is their source of earnings. So why does profitability exculpate the banks?

Mr. Bloom. Father Drinan, in a profit system, the only way I know to measure profit is by profit. I cannot answer in terms of one profit being better than another profit.

Mr. Drinan. My point is, sir, that you seek to refute the article in the Washington Post. But I have just re-read it. Frankly, I don't think that you have laid a finger on it. All of the contentions that are made here have not been rejected or refuted by you people. So I am left in a quandry of writing to my constituents this afternoon and telling them that we had the highest Federal officials testify and they have not refuted the article from the Washington Post. This is my conclusion.

Mr. Bloom. I haven't attempted to refute any articles.

Mr. Drinan. But James E. Smith did. He said, "I am at a loss. I emphatically and equivocally reject any such characterizations."

Was there at one time and until recently a list of banks that in code was called "Victor"?

Mr. Bloom. Yes, sir.

Mr. Drinan. When was that discontinued? That was the problem list, wasn't it? When did Victor go away?

Mr. Bloom. In September 1975.

Mr. Drinan. What do we call "Victor" now?

Mr. Homan. Father, that was not a list of problem banks. The section that succeeded "Victor" is the section that supervises the 65-percent banks.

Mr. Drinan. What is "Victor's" new name?

Mr. Homan. There is no code name for it.

Mr. Drinan. This nameless entity—is the list the same?

Mr. Homan. Father, I told the reporter from the Washington Post that if he could suggest a new name for us we would be glad to have it.

Mr. Rosenthal. Why don't you get in touch with the IRS? They had a whole series—Leprechaun, Trade Winds, Harry the Hat, and others.

Mr. Drinan. Is the list the same? Under "Victor"—a happy memory—there were 200 banks roughly out of 14,500 banks at any given time. Now the new, unnamed creature is more or less the same. And there are roughly 200 there at any given time. Is that right?

Mr. Bloom. I can't say that.

Mr. Drinan. Are there more or less?

Mr. Bloom. We are not following that system any more. You are going to have printouts from computers on any number of different ratios. So I can't compare the "Victor" list with what we will have in the future because it isn't just a case of changing the name. We are changing our whole approach for singling out banks for special attention. We are not just changing the name of a list.

Mr. Drinan. In other words, it is even more difficult for us in the Congress to find out the problem banks. You say it is all kept in a different way, but it comes out the same way to me. You may have changed the bookkeeping, but it is a nonsystem now in that you are not even telling yourselves how many banks are in trouble. You used to say there were roughly 200. Right?

Mr. HOMAN. Again, they were never considered to be problem banks. They were banks that were to be given further analysis by a professional staff analyst. Then the level of supervision was determined.

Mr. DRINAN. Because they had problems.

Mr. HOMAN. Not necessarily.

Mr. DRINAN. Then you people had problems with them. But in any event, these are the banks and now all of a sudden they become more lost, so to speak, to the public and even to the Congress.

In the series of investigations that this committee is going to conduct, we have to go into real estate trusts and the REIT. In the Washington Post article, they said that the two banks in question, Chase Manhattan and First National City Bank, had overfinanced the real estate investment and that some of their largest and worst losses came as a result of high-risk ventures in real estate. Would you have some comment on that?

Mr. BLOOM. There is no question about that.

Mr. DRINAN. Well, this is a problem that we have to investigate. Now in late 1975 the Federal Reserve, and I am reading from your own document here, denied an application from Citicorp—that is the parent holding company of City Bank. They denied an application to acquire three west coast financing corporations. Could you tell us the background of that decision? What information was available then that they knew that City Bank should not move into these ventures?

Mr. BLOOM. I am sorry, Father Drinan, but I really don't have the information to comment on a Federal Reserve application.

Mr. DRINAN. It is a Comptroller application. I am sorry. But if you don't want to tell us, you don't want to tell us.

Mr. HOMAN. That application was made to the Federal Reserve, not to the Comptroller. It was a holding company acquisition, as I recall.

Mr. DRINAN. This brings up another question which is obviously related. Do you people have any viewpoints on the proposed consolidation of all of these bank regulatory agencies so that we don't have to torture three different agencies?

Mr. HOMAN. We have been responding to the House Banking and Currency Committee's fine study and recommended that supervisory decisions such as approval of holding company acquisitions be transferred to the agency which supervises the majority of the bank assets under that holding company.

Mr. DRINAN. That does not properly come within this subcommittee.

Mr. ROSENTHAL. Any reorganization of any agency will come to the Committee on Government Operations and I presume anything to do with these regulatory agencies would come to this subcommittee. So these inquiries are leading, I hope, down the road to appropriate legislation.

Mr. DRINAN. Let me come back to the work of your own agency. I read here from the Comptroller's report of last year that the intent of Congress is that every bank be examined twice a year, but the statute gives the Comptroller the discretion to waive one examination every 2 years.

Now as I read what has transpired, the Comptroller has apparently exercised that discretion so that it is a routine thing now to have only three examinations in 2 calendar years and the omission of one is regular for everybody. Is that a fact and is there any explanation?

Mr. BLOOM. It is quite common. Our resources, as are those of other Government agencies, are stretched pretty thin. And as long as a bank is in a normal condition, that is certainly true. However, if we get a bank under special surveillance, we could be going in every week or every month.

Mr. DRINAN. Have you ever, in the last 6 years, waived an examination of the Chase Manhattan or City Bank?

Mr. BLOOM. Yes.

Mr. DRINAN. You have?

Mr. BLOOM. Surely. The examination of Chase and City takes so long that we are in there half of the time anyway.

Mr. DRINAN. Have you ever asked Congress for more examiners in this time of recession? It would create jobs. Have you ever asked? You can't come out clean on this one, sir. If you say that you needed more examiners and didn't ask for more examiners, this is the committee to come before.

Mr. HOMAN. I suppose that is correct, Congressman. The question has been structured so that we can't come out clean.

Mr. DRINAN. There were 648 special examinations and visitations conducted in 1974.

Mr. BLOOM. Our examiners spend more time in Chase and City probably than in any bank in this system as far as point of hours or days spent. But that is because the banks are so large that it takes 5 or 6 months to complete an examination. It is not because we have any special concerns.

Mr. DRINAN. Would you tell us, sir, when you waived examinations of these banks?

Mr. BLOOM. The last examinations of Chase and City—the ones the newspapers are talking about—started in July and ended in January in the case of Chase. In the case of City, one of them started in January and ended in July.

Mr. DRINAN. That is one of the annual examinations. Now you have said that you did waive them and I am just asking them.

Mr. BLOOM. And we conducted two of them in a 3-year period. This meant that we were in Chase and City more often than we were out of them.

Mr. DRINAN. When did you waive them?

Mr. HOMAN. We were in Chase and City for a full year out of that 2-year period because from start to finish the examiner monitors those banks.

Mr. DRINAN. But they had one examination and not two. And the intent of Congress and the statute says that national banks shall be examined twice in each calendar year, but the Comptroller in the exercise of his discretion may waive one such examination in a 2-year period. Now you have told me that he has exercised this discretion with regard to both of these banks.

Mr. BLOOM. Yes; but it had absolutely no effect on the quantity of these examinations because of the length of time it takes to examine them. If we hadn't waived it, we would have been in the same amount of time. You just would have had three separate packets of paper instead of two.

Mr. DRINAN. Tell us about these special visitations that some banks get. Did Chase and City have any special examinations or visitations? In 1974 you had 648 of these. Who makes the decision as to when these 648 were visited and why?

Mr. BLOOM. The Regional Administrator commonly makes those.

Mr. DRINAN. That indicates a little difficulty in these 648.

Mr. BLOOM. It may.

Mr. DRINAN. You don't go in just to pass the time of day. What kind of difficulty triggers a special visitation?

Mr. BLOOM. Various things.

Mr. DRINAN. Did you ever have a special visitation of City or Chase Manhattan?

Mr. BLOOM. Again, we are in there so much of the time that it would be meaningless to declare that a particular day's visit was a special visitation. We are in and out of these large banks all of the time.

Mr. DRINAN. I am getting the impression that with all of these large banks that you have a continuous examination and that this statutory language of doing it twice a year has no meaning.

Mr. BLOOM. That is correct.

Mr. DRINAN. Why haven't you told the Congress that before?

Mr. BLOOM. We have on occasion. That particular statute, like many sections of the National Banking Act, is badly in need of revision.

Mr. DRINAN. Tell us more about these special visitations. If we conclude that you didn't exercise the power that the Comptroller has——

Mr. BLOOM. I don't concede that at all, Congressman. We have done a better job in examining these two banks, I would say, than virtually any other bank in the system.

Mr. DRINAN. Well, all I have is what Mr. Smith has said. I have taken notes, and I want to get an answer so that I can say that the Washington Post was alarmist and that the facts that they have here do not add up to any conclusions that people should act upon. But I am not getting that.

To come back to this, this is the only official refutation. I have gone through the three or four paragraphs and it is not satisfactory to me. So what, therefore, should I do?

Mr. MURPHY. Mr. Congressman, may I make a stab at the relationship that we have all been grappling with this morning between loan losses and bank earnings?

Mr. DRINAN. Yes.

Mr. MURPHY. This has a great deal to do with these particular two banks. The loan losses come out of one of three places and it goes in ascending order, if you will. The first place a bank looks to cover its loan losses is current incomes—that year's income. The next place is the provision for loan loss, the reserve that has been set aside out of income. The final place is the capital.

Now what the Comptroller was attempting to say in his statement was—and let's take Chase as an example. It is a matter of public record as to what their chargeoffs were. It is a matter of public record as to what their provisions were for loan losses. They were both above the levels that have been normal in the last 10 years or the last 20 years.

Mr. DRINAN. They are above historic norms.

Mr. MURPHY. I think by historic we were talking in the near term. I am really not certain what Mr. Smith had in mind. To me, that statement means in the last decade or the last 20 years. In any event, even with those loan losses and even with setting aside an unusual amount in reserve, the net earnings for Chase Manhattan, as I understand it, are the second highest in the history of that bank.

Mr. DRINAN. That means that the depositors and borrowers are getting ripped off or something.

Mr. MURPHY. The biggest limitation on the interest paid a depositor is a regulation fostered by an act of Congress.

Mr. ROSENTHAL. We shall conclude. Mr. Bloom, the subcommittee will address to you a communication in the next 24 hours regarding more specific information concerning pages 8 through 11 of your statement.

Additionally, I want to say that I know of no other situation where an official of the executive branch has absolutely coldly refused to provide requested, directed information to a subcommittee, a committee of the Congress—particularly when the offer was made to do it in executive session.

I do not know, nor can I recall, that either the Defense Department, the State Department, the Central Intelligence Agency or any of them taking the obstinate, arbitrary, capricious attitude that you have taken here today.

I do not mean this to be personal. I assume you are doing it on behalf of your superior and on behalf of the agency.

The chain of events that follow is this. This subcommittee has voted 6 to 1 to recommend the full committee an issuance of subpena. We will bring that matter before the full committee this Thursday morning. Hopefully, they will act in a fashion consistent with the action of the subcommittee. We will proceed according to the Rules of the House of Representatives. And we will hold you accountable to the Rules of the House of Representatives and the statutes as vigorously as we can.

The subcommittee stands adjourned.

[Whereupon, at 12:27 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF FEDERAL BANK REGULATION

(Regulation of Problem Banks)

TUESDAY, FEBRUARY 3, 1976

House of Representatives,
Commerce, Consumer,
and Monetary Affairs Subcommittee
of the Committee on Government Operations,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:35 a.m., in room 2154, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Robert F. Drinan, Elliott H. Levitas, David W. Evans, Andrew Maguire, and John N. Erlenborn.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Ronald A. Klempner, counsel; Doris Faye Taylor, clerk; and Stephen M. Daniels, minority professional staff, Committee on Government Operations.

Mr. Rosenthal. The subcommittee will be in order. Today's hearing by the Commerce, Consumer, and Monetary Affairs Subcommittee is a continuation of the review of the efficiency and adequacy of Federal bank regulation of so-called problem banking institutions.

Today the subcommittee will hear the testimony of Mr. Brenton C. Leavitt, Director of Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. Mr. Leavitt has been asked to review the practices and procedures of the Federal Reserve with regard to the so-called problem banks and problem bank holding companies.

Mr. Leavitt, we are pleased to have you with us. You have a prepared statement. We are anxious to hear it.

STATEMENT OF BRENTON C. LEAVITT, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, AND PROGRAM DIRECTOR FOR BANK STRUCTURE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; ACCOMPANIED BY JOHN E. RYAN, ASSISTANT DIRECTOR; AND JOHN E. HAWKE, GENERAL COUNSEL

Mr. Leavitt. Mr. Chairman, I am pleased to respond to the committee's request for information concerning the adequacy and effectiveness of the examination, supervision and regulatory functions of the

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Federal Reserve System. In this connection, I note that the committee indicated a particular interest in these functions as they relate to so-called problem banks and problem bank holding companies.

The term "problem", as it is applied to the lists of banks and bank holding companies recently reported in the Nation's press, is an unfortunate one because, in most instances, it implies a more serious situation than exists. These lists are maintained internally for purposes of insuring that closer supervisory attention is given those institutions that are experiencing some areas of weakness or that have exposure to stress. Such lists are designed to aid in this process and normally contain a summary of the firm's financial condition, a brief discussion of its weakness or potential difficulty, the supervisory followup action taken and the progress being achieved.

I wish to emphasize that institutions appearing on these lists are rarely in danger of failure. It should be noted that the news stories concerning these banks and bank holding companies were based on information that dealt with the condition of the banks and debtors as it appeared in the depth of this country's most severe recession since the 1930's. The picture looks much brighter now for both banks and their debtors. For the most part, the banks have identified their weaknesses, have instituted corrective action and have clearly demonstrated the financial capacity and underlying strength to overcome their difficulties.

Having noted our belief that prospects are improved and that the problems are manageable, I do not wish to dismiss the difficulties that were encountered and, to some extent, still exist. Clearly, the heavy loan losses that have been reported by many major banks is an indication that the difficulties were far from slight. The nagging questions that this raises are: Why did these difficulties occur, and who was responsible for them? Our staff at the Federal Reserve believes the underlying cause of the weakness that became apparent in the recent recession can, to a significant extent, be traced to the general economic and financial excesses of the early 1970's. These excesses, however, were by no means confined to the banking system. This was a period of rapid growth of the economy and one in which a mood of unbridled optimism prevailed. Much of American business was staffed and influenced by executives who were born in the 1940's, schooled in the 1950's and 1960's, and who had never experienced a severe economic reversal. Mistakes under such circumstances were inevitable. With the the advantage of hindsight, it is clear that American business should have proceeded in certain areas with more caution than it did.

One well publicized area that has resulted in a number of troubled loans for banks is the real estate investment trust industry. The "REIT"—designed to provide needed funding for housing and other real estate projects, and existing because of tax advantages bestowed by Congress—is an example of the dangers of too much too soon. The enormous volume of funds that were pumped into the construction industry by the REITS resulted in overbuilding in certain areas and ill-conceived projects in others. These difficulties, together with other stresses in the economy, exacerbated by the energy crisis, were major factors accounting for the increases in the volume of troubled loans in the portfolios of some of the Nation's banks. That the bankers or the regulators, for that matter, should have had the foresight to anticipate and thus avoid all of these problems is perhaps expecting too much.

Nevertheless, the supervisory process was at work during the period of the early 1970's. Let me summarize for you the broad supervisory steps that the Federal Reserve took during this period:

April 1973—a letter signed by Chairman Burns was sent to the Chief Executive Officer of each State member bank with deposits exceeding $100 million concerning their loan commitment policy. The letter stated in part that "... The apparent large volume of bank commitments currently outstanding and sharply increased takedowns thereunder are indicative of the need for special attention to this subject at this time ...".

May 1973—a letter signed by Chairman Burns was forwarded to all State member banks requesting their cooperation in assuring that the rate of credit extension be appropriately disciplined. The letter stated in part "Some key segments of the Nation's economy are now growing at an unsustainable pace, thereby adding substantially to inflationary pressures. Since excessive bank loan expansion is a factor in this development, the Federal Reserve last week supplemented its previous policy actions by adopting several regulatory amendments with a view to further curbing such expansion. I am writing to you and every other member bank today on behalf of the Board to give emphasis to these recent actions and to invite your personal cooperation in assuring that the rate of credit extension by your bank is appropriately disciplined ...".

June 1973—a letter was sent by Chairman Burns to about 100 foreign owned banking institutions in the United States. The letter requested cooperation in assuring that the rate of bank credit expansion in the United States is restrained.

September 1974—the Board released a statement on bank lending policies that had been received from its Federal Advisory Council. The letter urged that banks discipline their lending policies so as to exclude loans for speculative purposes.

Beginning in early 1974 and continuing through 1975, the Board began formulating policies concerning bank holding company expansion. A so-called "go-slow" policy was adopted because it was believed that managerial and financial resources could often be used more effectively to strengthen the existing operations, particularly in the bank subsidiaries, some of which had experienced sharply declining capital ratios.

In 1974 and 1975, the Board through its statutory powers concerning applications for foreign expansion, denied a number of applications of major banks stating, in effect, that the capital of the organization should be used to support existing business rather than more expansion.

Moreover, during this time, examiners were examining individual banks, and discussing with management any significant problems. When needed, examination personnel were requesting additions to capital, improvement in liquidity, and strengthening of lending policies. Federal Reserve Governors were speaking about these problems and urging that remedial steps be taken.

These actions obtained results. A number of banks' and bank holding companies' managements recognized their problems and realined their lending policies to obtain more sound credit decisions; improved, to the extent possible, their liquidity positions; added to capital by slowing the rate of increase in cash dividends; added to capital funds by sale of subordinated debt; and, finally, adopted more manageable growth and expansion goals. The impact of the recent recession on the banking system would have been much more severe than it was, if these actions had not been taken.

Let me now turn to the more specific areas of bank and bank holding company supervision. In discussing the Federal Reserve's supervisory role, the committee should bear in mind that the System has direct supervisory responsibility for State-chartered banks that are members of the Federal Reserve and responsibilities as they relate to the Board's duties as set forth in the Bank Holding Company Act. For the purposes of our discussion today, I propose to address banks and bank holding companies separately.

Regarding banks, more specifically State member banks, the criteria for "flagging" the institution for special supervisory attention include the quality of the institution's assets, the adequacy of its capital, the strength of its earnings, its liquidity position and the competency of its management. These considerations are reflected in what is known as a uniform rating system. A detailed description of the rating system is appended hereto. (See appendix I). It should be noted that there is considerable flexibility in the assignment of individual ratings, and factors other than those explicitly enumerated in the attached description, particularly earnings and liquidity, are considered.

At the conclusion of each examination of a State member bank, the Reserve Bank rates the condition of the bank on a scale of 1 to 4 based on information developed by the examiners. I have attached a list of ratings of State member banks examined by the Federal Reserve during the years 1971 and thru 1975 to the extent the reports have been completed. (See appendix II). Tho Board of Governors does not review or pass on these ratings although it does receive periodic staff reports on the condition of banks in the various categories. Banks determined to be in satisfactory condition in all major respects are given a rating of 1. About 66 percent of the more than 1,000 State member banks qualify for such a rating.

Banks with one or more deficiencies in asset quality, level of risk assets, management strength, or liquidity, may be given a rating of 2 unless their capital position is strong enough to offset such deficiencies. Banks in this category include many sound institutions that serve their communities very well. Ordinarily, the managements of these banks respond promptly to examiner criticisms.

Category 3 includes largely those banks having a relatively high volume of loans that need careful attention. Over the past 2 to 3 years, there has been an increase in the number and especially in the size of banks placed in this category. As I mentioned, I believe the underlying cause of this increase can, to a significant extent, be traced to the excesses of the early 1970's that became apparent in the recent recession.

Category 4 includes banks with capital that has been impaired and with aggravated deficiencies present in condition and management. These banks usually require prompt and extensive attention to restore them to satisfactory condition. Only a few State member banks are so rated. less than five in any recent year.

While there are a number of banks that have been flagged for special surveillance, the second table (appendix III), illustrates that there has been a significant turnover in individual banks on the list. Since the beginning of 1970, for example, 75 banks have been removed from the special surveillance category while 107 were added. These data demonstrate that most banks, upon recognizing and identifying areas of trouble and potential trouble, are able to institute corrective action and overcome their difficulties. This is an indication of the resiliency of the banking system. We believe that it also illustrates that supervisory efforts on the part of the Federal Reserve are timely and obtain results. Moreover, as economic conditions improve, banks should be able to improve the condition of their loan accounts even more rapidly.

Although the Federal Reserve believes that recent events tend on balance to confirm the appropriateness of its supervisory policies, it nevertheless has been conducting a number of studies to develop even better means for preventing such situations from occurring and for resolving them as soon as possible. Attention has been focused on a number of issues including the following: the attenuation of bank capital produced by the rapid expansion of bank assets partly, but not entirely, induced by inflation; bank liquidity problems, particularly heavy reliance on liability management; a deterioration in the quality of bank assets; increased risk of losses in bond trading departments of banks; and, the improvement and updating of examination techniques and procedures.

As a result of these studies and recent banking developments, the Board has made several legislative proposals and has proposed changes in certain regulations. Steps have also been taken to strengthen and expedite followup procedures, and guidelines delineating a graduated range of alternative procedures to be implemented in correcting troublesome cases have been adopted. The steps range from early attempts at "moral suasion" to meetings of the bank supervisors with boards of directors, and, in aggravated cases, the issuance of cease and desist orders. Since 1972, the Board has issued 17 cease and desist orders. The orders have dealt with such problems as deficiencies in loan collection policies, excessive dividends, insider dealings, unsound securities transactions, etc.

Turning briefly to the area of bank holding company supervision, I would like to note that the difficulties that have been experienced here are interrelated with bank problems but are also unique in some respects. Although there have been a number of acquisitions of nonbank entities by bank holding companies since the 1970 amendments to the Bank Holding Company Act, in terms of assets or earnings, holding companies, for the most part, are overwhelmingly dominated by their banks.

The Board's interest in bank holding companies is twofold. First, since it is responsible for determining permissible activities, it has a particular interest in the financial soundness of these new ventures and their impact on the overall stability of the banking system. Secondly, the Board also has responsibility for general oversight of bank holding companies and for considering the financial and managerial resources of individual holding companies in connection with action on applications submitted. In connection with these various responsibilities, the Federal Reserve has undertaken efforts to monitor the financial condition of bank holding companies and their nonbank subsidiaries.

The primary consideration in "flagging" a bank holding company for special surveillance and monitoring include the condition of its subsidiary banks, the ability of the parent holding company and its nonbank subsidiaries to meet their cash needs, the asset condition of significant nonbank subsidiaries as well as the impact of the operations of these entities on the overall profitability of the organization.

The analytical process focuses on the impact of the parent bank holding company and the nonbank subsidiaries on the subsidiary bank. Experience has indicated that there are three potential hazards. The first relates to the public's identification of the holding company and the nonbank subsidiaries with an affiliated bank and the adverse impact that failure of a nonbank subsidiary may have on the public confidence in the bank. The second arises from the risk that strains in the nonbank subsidiaries and holding company may result in the transfer of inferior assets from the nonbank subsidiaries or parent bank holding company into the bank. The third results from the excessive dependency of the bank holding company upon the subsidiary banks for needed cash flow, generally in the form of dividends.

With respect to the second concern, the Board recently asked the presidents of the Reserve Banks to forward a letter to the chief executive officer of all bank holding companies, noting that the sale of assets from a nonbank subsidiary to a bank could be a violation of section 23(A) of the Federal Reserve Act. The letter is attached for the committee's information. (See appendix IV.)

The third potential problem is exacerbated by the existence of excessive debt in the holding company which may cause unduly large dividends to be paid by the bank to its own detriment. One method that may contribute to such condition is a technique called "boot-strapping". Briefly, "bootstrapping" is a process whereby the holding company, with the proceeds of loans that are generally secured by stock of the subsidiary banks, purchases its own shares, thereby reducing its net worth and increasing its debts. On December 11, 1975, the Board published for comment a proposed amendment to its holding company regulation designed to deal with this specific problem. A copy of that proposed amendment is attached. (Appendix V.)

The Board believes that the bank holding company should serve as a source of strength for its subsidiary banks. In those few cases where the operation of the bank holding company constitutes a threat or potential drain on the strength of the bank, as I outlined above, that holding company is designated for special surveillance.

In January 1975, 35 separate bank holding companies were included on the Federal Reserve's list of bank holding companies receiving more than normal supervisory attention. With respect to individual companies included in the January 1975 report, improvement in the economy and management's awareness of their respective problems as well as the implementation of corrective programs have ameliorated many of the adverse conditions indicated in that report.

At the present time, the Board's staff is monitoring the condition of 63 bank holding companies, some of which were included in the January 1975 report. While the total number of companies has increased, it should be remembered that improvement relating to certain types of loans and to certain regional economies typically lags behind recovery in the national economy. Therefore, we feel confident that continued improvements in the national economy and vigorous supervision will result in a reduction in the number of holding companies requiring supervisory attention.

In discharging its responsibilities as outlined in the Bank Holding Company Act, the Federal Reserve has at its disposal a number of supervisory tools which can be employed to meet specific objectives. Perhaps the most effective supervisory measure available to the Board is its statutory authority to permit or deny holding company acquisitions and expansion. Denial of applications or conditioned approvals have proven to be valuable in achieving correction of troublesome bank holding company situations.

In addition to the applications process, staff of the Federal Reserve meets with selected holding company managements to discuss unsatisfactory trends and to review progress under corrective programs that are in place. In some five cases where it was deemed warranted, the Reserve Bank has entered into agreements in writing with holding companies. Such agreements set forth certain conditions and outline corrective measures. In aggravated cases, the Board has also used its authority under the Financial Institutions Supervisory Act. Since it received such authority in 1974, the Board has taken 10 cease and desist actions against bank holding companies.

We believe that the present remedies available to the Federal Reserve are sufficient to effect correction in the most troublesome areas. Nevertheless, as a result of a continuous review of the bank holding company movement and its effect on the banking system, we fully expect that, from time to time, the Federal Reserve will seek new legislation designed to deal with the changing environment. One item of legislation that would be especially helpful would be authority to assess civil penalties for violations of the Bank Holding Company Act. That and other legislation was recommended to Senator McIntyre by Chairman Burns in his letter of September 5, 1975. [Copy attached as Appendix VI.]

In conclusion, let me reiterate that while there are banks and bank holding companies in the United States with some fairly serious asset problems, we believe that both banks and bank holding companies have demonstrated the capacity to correct these difficulties given a reasonable period of time. Furthermore, we believe that supervisory efforts of the Federal Reserve prevented the development of more serious situations and have helped to prompt the remedial actions now underway.

I thank you, Mr. Chairman.

[The appendixes to Mr. Leavitt's statement follow:]

Appendix I

¶ **2400.70 Uniform system for rating commercial activities of member banks.** [Feb. 17, 1960, S-1730 as amended by S-2094 of July 22, 1969.] While any Federal Reserve Bank may continue to use for its own purposes any method of rating banks it may consider desirable, it is requested that, for the purposes of the Board of Governors, all State member banks be rated in accordance with the below described formula which is essentially the same as that used by the Comptroller of the Currency for rating national banks. The rating as determined by the formula should be entered and initialed by the Vice President in Charge of Examinations at the bottom of page E of the confidential section of the report of examination as follows:

$$\frac{\text{1-A-S}^*}{1} \quad \text{(initials)}$$

In order that the transmittal to the Board of copies of reports of examination of State member banks may not be delayed by the absence of the Vice President, the Board will accept the initials of the Chief Examiner, the Manager of the Bank Examinations Department, or another officer of the Reserve Bank provided the Vice President in Charge of Examinations will promptly review all such reports and advise the Board of any adjustments in the rating as originally reported which he may consider desirable as a result of his review.

Composite or Group Rating

Rating No. 1

Banks rated No. 1 should be sound institutions in every respect.

Rating No. 2

Banks rated No. 2 are those with (a) asset weaknesses ranging from relatively moderate to moderately severe, or (b) negligible asset problems but definitely undercapitalized, or (c) unsatisfactory managements, or (d) a modified combination of these and other weaknesses.

Rating No. 3

Banks should be rated No. 3 which have, in relation to capital protection, an immoderate volume of asset weaknesses which, in view of the (a) character of the asset problems, or (b) management deficiencies, or (c) economic conditions, or a combination of these and other points, could reasonably develop into a situation urgently requiring aid either from the shareholders or otherwise. Banks in this category require special attention.

* Rating symbols for capital positions, quality of assets and, management are shown above the line in that order, the composite or group rating symbol is shown below the line.

Rating No. 4

Banks rated No. 4 are those confronted with asset weaknesses of a character and volume, in relation to capital protection and quality of management, urgently requiring aid from the shareholders or otherwise and whose failure, if such aid is not forthcoming, would appear to be probable. These are the serious or hazardous cases requiring constant supervisory attention.

Capital Position

Rating No. 1 or Roman Numeral I

Capitalization adequate in relation to

(a) volume of risk assets, *and*
(b) volume of marginal and inferior quality assets, *and*
(c) volume of deposits.
(d) Points a, b, and c to be considered in relation to strength of management.

Capitalization will not be considered adequate unless in the judgment of the Vice President in Charge of Examinations it is adequate in relation to the above enumerated points. Consideration will, of course, be given to earnings retention capacity. Ratios are not the primary determinant of this rating. Judgment must be exercised in deciding whether capital-wise a bank comes within this category. Although some banks will be regarded as undercapitalized with better ratios, in general a bank will be considered undercapitalized if (a) its ratio of total capital structure to total assets is worse than 8%, (b) its risk asset ratio is worse than 12.5%, or (c) its ratio of actual capital to the requirement under the Form for Analyzing Bank Capital is less than 80%. But in any case where a bank has either a ratio of total capital structure to total assets worse than 8%, a risk asset ratio worse than 12.5%, or a ratio of actual capital to the requirement under the Form of less than 80%, and the institution is believed to be adequately capitalized and deserving of a number 1 capital rating, this judgment will be so indicated by using Roman Numeral I.

Rating No. 2

Capitalization inadequate in relation to

(a) volume of risk assets, *or*
(b) volume of marginal and inferior quality assets, *or*
(c) volume of deposits.
(d) Points a, b, and c to be considered in relation to strength of management

While adequate capitalization is based on adequacy in relation to points a, b, and c, as a group, and the weighing of those three points in relation to management competency, capital inadequacy may exist because of the adverse relationship of the capital structure to any one of the first three points (a, b, or c), giving due weight to management as a possible mitigating factor, but not beyond a reasonable point. The least important factor is the relationship of capital to deposits unless extreme. The Federal Reserve Bank officials must exercise their own best judgment with reasonable emphasis on conservatism in determining capital adequacy or inadequacy for rating purposes. The exercise of judgment is required by the use of Roman Numeral I for those banks considered adequately capitalized despite ratios that normally would be regarded as sufficiently adverse to warrant a 2 or inadequate capitalization rating.

Rating No. 3

Inadequate capitalization is worse than defined under No. 2 above and is regarded as hazardous. This normally will include all banks whose aggregate of classified assets is sufficient to impair the capital account.

Rating No. 4

Capital impaired by losses.

Quality of Assets

Rating A

Good. Ordinarily banks so classified will not have an aggregate total of (1) classified assets, plus (2) 50% of Other Loans Specially Mentioned, plus (3) unclassified speculative bonds, stocks, and other real estate, that is in excess of 20% of the gross capital structure*, and the character of the problems in such assets is not severe in the judgment of the Federal Reserve Bank officer making the rating. An aggregate total of such assets somewhat in excess of 20% of the gross capital structure will not preclude an A rating, provided the actual or potential seriousness of the problems in the assets concerned is regarded as relatively moderate. However, if the primary asset problems are regarded as severe, or if additional problems exist in Large Lines, bond concentrations, or a heavy investment in fixed assets, a less favorable rating should be used even though the aggregate total of primary asset problems is less than 20% of the gross capital structure*.

Rating B

Fair. Instructions, and elasticity to exercise judgment through use of a more favorable or less favorable rating, are the same as noted under rating "A" except banks so classified ordinarily will not have an aggregate total of (1) classified assets, plus (2) 50% of Other Loans Specially Mentioned, plus (3) unclassified speculative bonds, stocks, and other real estate, that is in excess of 40% of the gross capital structure*.

Rating C

Unsatisfactory. Instructions, and elasticity to exercise judgment through use of a more favorable or less favorable rating, are the same as noted under rating "A", except banks so classified will *not* have an aggregate total of (1) classified assets, plus (2) 50% of Other Loans Specially Mentioned, plus (3) unclassified speculative bonds, stocks, and other real estate, that is in excess of 80% of the gross capital structure*.

Rating D

Hazardous. Any bank will be so classified when the total of (1) classified assets, plus (2) 50% of Other Loans Specially Mentioned, plus (3) unclassified speculative bonds, stocks, and other real estate, is in excess of 80% of the gross capital structure*.

Management

S—Satisfactory

A "satisfactory" management (directorate and active officers) is adequate to all its responsibilities and has the ability to cope successfully with existing or foreseeable problems. It is a safe and competent management which has established a satisfactory record of performance *in the situation in which it is found.*

Note: The "S" rating does not necessarily connote a management which is superior or excellent, or representing experience or competence greater than required in the particular bank under review. New and untried management may be accorded an "S" rating pending demonstration of satisfactory performance, providing other related circumstances and disclosures do not indicate the use of a lower rating.

F—Fair

A "fair" management lacks in some measure the competence desirable to meet the problems of the situation in which it is found. Either it is characterized by mediocrity when above-average capabilities are called for, or it is distinctly below-average for the same type and size of bank. An "F" rated management may be safe at the moment but criticizable features of the bank's operations outweigh more favorable factors, and abilities to correct existing unsatisfactory conditions or trends are not impressive.

Note: The "F" rating does not connote satisfactory management (which is rated "S"). In all cases where it is assigned, management is lacking in some rather important respects, but deficiences are not sufficient to warrant the "P" rating. (Lack of adequate succession arrangements may, in some cases, be cause for assigning the "F" rating to an otherwise satisfactory management.) Banks with an "F" management rating would be accorded a composite rating no better than "2"; they often may warrant a "problem" rating because of a current unsatisfactory asset condition or capital position, or they may present rather strong evidence of deteriorating into that category unless improvement in management performance can be brought about promptly in response to supervisory action.

P—Poor

The description assigned the "P" rating is self-explanatory. The rating should be reserved for those cases where incompetency has been demonstrated or where management deficiencies are of such seriousness that the over-all characterization of "poor" is amply justified. In the cases so rated, problems resulting from management weakness or incompetence create so unsatisfactory a condition that management may need to be strengthened or replaced before sound bank conditions may be brought about.

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* For purposes of determining asset ratings, "gross capital structure" consists of the "total capital account" and total "valuation reserves" on loans and securities as shown on page [2] of the report of examination.

Appendix II

RATINGS OF STATE MEMBER BANKS
EXAMINED BY THE FEDERAL RESERVE DURING INDICATED YEARS

Composite Ratings
(Deposits in Thousands)

Year		All Ratings	Rating 1	Rating 2	Rating 3	Rating 4
1971	Number of Banks 1/	1,112	759	307	43	3
	Percent	100.00	68.26	27.61	3.87	.27
	Total Deposits 2/	102,878,429	36,913,386	63,419,800	1,352,142	1,193,101
	Percent	100.00	35.88	61.65	1.31	1.16
1972	Number of Banks	1,074	738	303	31	2
	Percent	100.00	68.72	28.21	2.89	.19
	Total Deposits	123,184,992	48,111,876	73,855,916	1,194,932	22,268
	Percent	100.00	39.06	59.96	.97	.02
1973	Number of Banks	1,044	736	278	30	0
	Percent	100.00	70.50	26.63	2.87	0.00
	Total Deposits	143,821,634	52,683,267	87,043,859	4,094,508	0
	Percent	100.00	36.63	60.52	2.85	0.00
1974	Number of Banks	1,026	711	266	45	4
	Percent	100.00	69.30	25.93	4.39	.39
	Total Deposits	162,279,629	54,155,893	56,039,479	51,967,233	117,024
	Percent	100.00	33.37	34.53	32.02	.07
1975 3/	Number of Banks	810	533	230	46	1
	Percent	100.00	65.80	28.40	5.68	.12
	Total Deposits	88,535,439	31,425,126	36,069,149	21,038,031	3,133
	Percent	100.00	35.49	40.74	23.76	0.00

1/ Number examined during the calendar year.

2/ Deposits as of the date of examination.

3/ Data for 1975 relate to the 810 banks for which examination reports have been completed.

Appendix III

Date	Banks under Special Surveillance	Additions	Deletions
12/31/65	43	15	20
12/31/66	38	16	23
12/31/67	49	22	11
12/31/68	43	14	20
12/31/69	35	12	20
12/31/70	39	13	7
12/31/71	48	15	6
12/31/72	36	10	22
12/31/73	29	5	12
12/31/74	38	22	13
12/31/75	65	42	15

The table above contains data on the number of special surveillance banks at the close of each calendar year commencing in 1965. Also included in the table are the numbers of additions to and deletions from the list of special surveillance banks during the calendar year. It will be observed that an inconsistency originating in 1966 was not adjusted until 1970.

Appendix IV

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

TO THE CHIEF EXECUTIVE OFFICERS OF ALL BANK HOLDING COMPANIES:

The purpose of this letter is to inform you of the Board's concern with respect to situations in which a bank holding company's banking subsidiary may have been exposed to adverse consequences because of transactions with the company's nonbanking subsidiaries. Such a situation would be one in which a banking subsidiary of a bank holding company has purchased assets of poor quality from a mortgage banking or consumer finance subsidiary of the holding company at prices significantly higher than they would bring in an "arms-length" transaction, thus contributing to problems in the subsidiary bank. Such a transaction could be in violation of Section 23A of the Federal Reserve Act. As you are aware, this section of the Act regulates extensions of credit between a member bank and its affiliates, including holding company subsidiaries, for the purpose of preventing adverse impacts on a bank through less than arms-length dealings with its affiliates.

In 1974 the Board published an interpretation of Section 23A reaffirming a 1958 interpretation, concluding that extensions of credit for purposes of Section 23A include purchases of obligations from an affiliate whether or not such purchases are made at a discount from face value. Thus, such extensions of credit would have to meet the amount and security limitations and requirements of Section 23A.

This interpretation is enclosed, and the Board wishes to emphasize that it continues to reflect the Board's view as to the applicability of Section 23A to this type of transaction. As the attached interpretation notes, however, the restrictions of Section 23A do not apply in those instances in which the transaction between the subsidiary bank and its affiliate is structured in an arms-length manner.

For example, when the commitment to purchase is made in advance of the extension of credit by the affiliate, and is based upon the bank's independent evaluation of the credit-worthiness of the borrower, Section 23A would not be applicable, inasmuch as "the member bank would be taking advantage of an investment opportunity rather than being impelled by an improper incentive to alleviate working capital needs of the affiliate that are directly attributable to excessive outstanding commitments." Furthermore, these restrictions do not in any way interfere with the strength that a holding company can provide to its affiliates through management expertise and capital injections rather than credit extensions.

Since the example described in the second paragraph involves a violation of Federal law, the Board wishes to call the attention of each bank holding company to the provision in question as well as to make it clear that the Board might consider cease-and-desist proceedings under the Financial Institutions Supervisory Act of 1966 to be appropriate in such circumstances. Further, the Board wishes to note that under certain circumstances, such as where assets are purchased for significantly more than they would bring in an arms-length commercial transaction, the transactions could constitute a misapplication of bank funds and subject the officers and directors involved to possible criminal liability (18 U.S.C. § 656).

Situations may arise where the transaction itself does not technically violate Section 23A, for example, a transaction with a real estate investment trust that is advised by an affiliate of a member bank. However, if such a transaction were to involve the purchase of poor quality assets at significantly more than they would bring in an arms-length commercial transaction, it could constitute an unsafe and unsound practice and might subject the institution to cease-and-desist proceedings under the Financial Institutions Supervisory Act of 1966. Further, under certain circumstances such purchases could, as noted above, constitute a misuse of bank assets that would subject any officers or directors involved to possible criminal liability.

The Board expects that all bank holding companies and their subsidiary banks will adhere to both the letter and the spirit of Section 23A. The staffs of the Reserve Banks remain available for consultation with respect to any proposed transaction about which you have questions. Further, the Board's staff, as well as the Reserve Banks' staffs, will be closely scrutinizing transactions between subsidiary banks, their affiliates, and other "related" institutions in accordance with the principles cited.

Enclosure

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

PART 250--MISCELLANEOUS INTERPRETATIONS

Transactions Between Member State Banks and their Affiliates

§ 250.250 Applicability of section 23A of the Federal Reserve Act to a member State bank's purchase of, or participation in, a loan originated by a mortgage banking affiliate.

(a) A question has been raised as to whether a member bank's purchase, without recourse, and at face value, of any mortgage note, or participation therein, from a mortgage banking subsidiary of its parent bank holding company at the inception of the underlying mortgage loan involves a "loan" or "extension of credit" from the member bank to the affiliate within the meaning of section 23A of the Federal Reserve Act (12 U.S.C. 371c). In the given circumstances, the affiliate originated the mortgage loans at premises other than an office of the member bank and hence was not a company furnishing services to or performing services for the holding company or its banking subsidiaries within the meaning of § 4(c)(1)(C) of the Bank Holding Company Act (12 U.S.C. 1843(c)(1)(C)). Loans or extensions of credit to the affiliate were therefore not entitled to exemption from the provisions of section 23A by virtue of subsection (1) of the final paragraph thereof.

(b) Paragraph 4 of section 23A provides that the term "extension of credit" shall be deemed to "include" the discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse, excepting the acquisition of such paper by a member bank from another bank without recourse. In previously interpreting the statutory provision from which this provision is derived (Section 6 of the Bank Holding Company Act of 1956, repealed July 1, 1966), the Board concluded that "discount" in the context of the statute meant "purchase" and that the purchase of notes, bills of exchange, conditional sales contracts or similar paper from an affiliate was subject to the prohibitions of the statute. (1958 Federal Reserve Bulletin 260.) Further, the Board notes that the definition in section 23A is illustrative rather than exclusive. The Board believes that the purposes of section 23A justify a broad construction of the definition of "extension of credit" to include certain purchases of obligations, even though the purchases are not made at a discount from face value. A bank's financing of the working capital needs of a mortgage banking affiliate may occur through outright purchases of obligations, and the types of abuses with which section 23A is concerned are likewise possible in such circumstances, since such transactions between affiliates could result in an undue risk to the financial condition of the purchasing bank.

(c) The Board is of the opinion that the purchase by a member State bank of a mortgage note, or participation therein, from a mortgage banking affiliate would involve a loan or extension of credit to the affiliate if the latter had either made, or committed itself to make, the loan or extension of credit evidenced by the note prior to the time when the member bank first obligated itself, by commitment or otherwise, to purchase the loan or a participation therein. However, there would be no loan or extension of credit by the member bank to its mortgage banking affiliate if the member bank's commitment to purchase the loan, or a participation therein, is obtained by the affiliate within the context of a proposed transaction, or series of proposed transactions, in anticipation of the affiliate's commitment to make such loan(s), and is based upon the bank's independent evaluation of the credit worthiness of the mortgagor(s). In these latter circumstances, the member bank would be taking advantage of an investment opportunity rather than being impelled by any improper incentive to alleviate working capital needs of the affiliate that are directly attributable to excessive outstanding commitments.

(d) The Board cautions, however, that it would regard a blanket advance commitment by a member State bank to purchase from its mortgage banking affiliate a stipulated amount of loans, or an amount thereof exceeding defined credit lines of the affiliate, that bears no reference to specific proposed transactions, as involving an unsound banking practice, unless the commitment is conditioned upon compliance of loans made thereunder with the requirements of section 23A. It would not suffice to condition such a commitment upon the bank's ultimate approval of the credit standing of the various mortgagors. That blanket commitment would have the inherent tendency, in the context of an affiliate relationship, to cause the bank to relax sound credit judgment concerning the individual loans involved when the affiliate was in need of bank financing, thereby resulting in an inappropriate risk to the soundness of the bank.

(Interprets and applies 12 U.S.C. 371c)

By order of the Board of Governors, August 2, 1974.

(Signed) Chester B. Feldberg

Chester B. Feldberg
Secretary of the Board

[SEAL]

FEDERAL RESERVE

press release

Appendix V

For immediate release December 11, 1975

The Board of Governors of the Federal Reserve System today proposed for comment a change in its Regulation Y -- regulation of bank holding companies -- to require prior notification by bank holding companies planning to purchase their own stock.

Comment will be received through January 15, 1976.

The proposed amendment is designed to deter "bootstrapping" operations, by which a bank holding company goes significantly into debt to purchase its own stock. In "bootstrapping" cases the stock redemption is typically followed by a transfer of ownership.

The Board is aware that there are legitimate reasons for a bank holding company to buy its own stock. Its proposal resulted, however, from concern about redemptions that result in circumstances such as the following:

-- The "bootstrapped" bank holding company is left with heavy debts and much reduced, perhaps very little or no equity.

-- Repayment and servicing of the debt depends mainly upon dividends the holding company receives from its subsidiary bank or banks, resulting in substantial pressure on them to pay excessive dividends to the parent company, possibly creating an unsafe or unsound bank condition.

-- The need of the holding company to meet heavy debt service obligations may encourage undue risk-taking aimed at increasing the earnings of its subsidiary bank or banks.

The proposal for prior notice of "bootstrapping" stock redemptions was made in order to avoid difficulties that may be encountered in unwinding or remedying the effects of such transactions once they have been concluded.

The Board therefore proposed that prior notification is necessary when:

-- The amount to be paid for the redeemed shares, plus the amounts paid for all other such redemptions or purchases in the last five years, equals 10 per cent or more of the holding company's current net worth.

The Board proposed that 60 days prior notice should be given to the appropriate Federal Reserve Bank, and the proposal also specified what information would be required. This information is provided in the attached copy of the Board's order.

The Board said that if a notice of a proposed transaction indicated a possibly unsafe or unsound condition might result, it would use its cease and desist authority, if necessary, to prevent consumation.

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Attachment

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS

[Reg. Y]

PART 225--BANK HOLDING COMPANIES

Notice of Proposed Rulemaking Concerning Purchase or Redemption by Bank Holding Companies of Their Own Shares

The Board of Governors has become aware of a number of instances in which bank holding companies have redeemed or repurchased a substantial portion of their outstanding voting shares in connection with a transfer of control of the holding company. Typically, such cases involve closely held holding companies, and the funds used to repurchase the outstanding shares are borrowed by the holding company, either from a third party or from the selling shareholder himself. Following the repurchase or redemption, the selling shareholder transfers the few remaining shares he holds to a new purchaser for nominal or minimum consideration. The new purchaser thus acquires control of a holding company encumbered with indebtedness that substantially represents the cost of acquisition of the holding company itself.

In such cases, the repurchase or redemption of shares by the holding company serves no corporate purpose; rather, it is intended solely to facilitate a transfer of control by the controlling shareholder or shareholder group. In certain cases that have come to the Board's attention, moreover, the volume of debt incurred by the holding company involved in such a "bootstrapping" transaction has rendered the holding company insolvent or has caused it to be in unsafe or unsound condition. The Board recognizes that there are many legitimate reasons why bank holding companies may wish to repurchase or redeem their own shares, and believes that a requirement that holding companies obtain prior Board approval for all such transactions may be unduly burdensome and unnecessary to cure the "bootstrapping" problem. For this reason, the Board has determined to initiate this rulemaking proceeding to propose a requirement that bank holding companies give prior notification to the appropriate Federal Reserve Bank of an intention to repurchase or redeem shares where the consideration to be paid, when aggregated with the consideration paid for all other repurchases or redemptions during the preceeding five years, would equal 10 per cent of the holding company's current net worth. The Board may, as an alternative, consider imposing such a prior notice requirement with respect to all proposed repurchases or redemptions by bank holding companies, or, alternatively, with respect to those involving the incurring of debt or a transfer of control.

Where such notice discloses that consummation of the proposed repurchase or redemption would violate applicable law or would create an unsafe or unsound condition in the holding company, the Board would, in appropriate cases, invoke its authority under the Financial Institutions Supervisory Act of 1966 (section 8(b) of the Federal

Deposit Insurance Act) to institute cease-and-desist proceedings against the company in order to prevent the repurchase or redemption.

For the foregoing reasons, the Board proposes to amend Regulation Y as follows:

Part 225 of Regulation Y is amended by adding thereto a new section 225.6, as follows:

SECTION 225.6--CORPORATE PRACTICES

(a) Purchase or redemption by a bank holding company of its own shares. No bank holding company shall purchase or redeem any shares of its outstanding voting securities without giving at least 60 days prior notice thereof to its Federal Reserve Bank if the consideration to be paid for such purchase or redemption, when aggregated with the consideration paid for all other such purchases or redemptions over the preceding five-year period, would equal 10 per cent or more of said holding company's consolidated net worth as of the date of such notice. The 60-day period shall begin to run from the date such notice is received by the Reserve Bank, which shall promptly acknowledge receipt thereof in writing. Each notice filed hereunder shall furnish the following information: (i) the title of the security to be purchased or redeemed, (ii) the number of shares of that security to be purchased or redeemed, the total number of such shares outstanding as of the date of the notice, and the number of all other such shares purchased or redeemed over the preceding five-year period, (iii) the consideration to be paid for the shares to be purchased or redeemed, and the consideration paid for all other such shares purchased or redeemed over the preceding five-year period, (iv) the date upon which or the period of time during which the purchase or redemption will occur, (v) the names of the persons from whom the shares are to be purchased or redeemed, and the names of persons from whom all other such shares were purchased, (vi) if debt is to be incurred or has been incurred by the company or a subsidiary in connection with the purchase or redemption or any other such purchase or redemption over the preceeding five years, a description of the terms of the debt, including the identity of the obligee, and the interest rate, maturity and repayment schedule of the debt, (vii) if a transfer of control is involved, a description of the terms of the transfer, including the identity of the transferee and a copy of any agreements relating to such transfer, and (viii) a current and pro forma consolidated balance sheet of the holding company. The Reserve Bank may permit a purchase or redemption to be accomplished prior to the expiration of the 60-day period if it determines that the repurchase or redemption would not constitute an unsafe or unsound practice and would not violate any applicable law, rule, regulation or order, or any condition imposed by, or written agreement with, the Board.

This notice of proposed rulemaking is issued under the authority of sections 5(b) and 5(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. §§ 1844(c) and (d)), and section 8(b) of the Federal Deposit Insurance Act, as amended (12 U.S.C. § 1818(b)).

To aid in the consideration of this matter by the Board, interested persons are invited to submit relevant data, views, or arguments in writing on the proposal and the alternatives described above, to the Secretary, Board of Governors of the Federal Reserve

System, Washington, D. C. 20551, to be received not later than January 15, 1976. Such material will be made available for inspection and copying upon request except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR § 261.6(a)).

By order of the Board of Governors, December 10, 1975.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

[SEAL]

Appendix VI

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SEP 1975

The Honorable Thomas J. McIntyre
Chairman
Subcommittee on Financial Institutions
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

Accompanying this letter is a proposed bill encompassing several joint recommendations by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency. All of these recommendations arise from the agencies' concern over "problem bank" situations and are designed to help prevent or correct such situations.

Sections 1, 2, 5, 6(e), and 7 of the bill would, in part, provide civil penalties for violations of various provisions of the Federal Reserve Act, the Federal Deposit Insurance Act, the Bank Holding Company Act of 1956, and the Financial Institutions Supervisory Act of 1966.

In recent years there have been a number of instances in which supervised banks have violated various provisions of law. The violations in question were of a type that could have an adverse effect on the safety or soundness of the banks, and no effective remedy has existed for such violations. For example, Section 23A of the Federal Reserve Act prohibits, in part, a member bank from lending to nonbanking corporations affiliated with it except to a very limited extent. In the absence of any specific penalties a bank holding company or other person experiencing financial pressure may cause the affiliated bank to violate the provisions of Section 23A, knowing that the sole remedy is a cease and desist order requiring reversal of the transaction. The presence of a daily money penalty should serve as an effective deterrent to such violations.

In assessing such a civil penalty, the agencies would be required to give due consideration to its appropriateness. In particular, they would have to take into account the financial resources and the good faith of the bank or person charged with a violation, the gravity of the violation, and the history of previous violations. We would hope that such a remedy would have to be used infrequently, if at all, and that its primary benefit would be in deterring violations by a member or insured nonmember bank, its officers and directors, or persons affiliated with such a bank.

For similar reasons primarily relating to deterrence, we also recommend, in sections 1 and 2, that civil penalties be provided for violations of Sections 19 and 22 of the Federal Reserve Act. The former relates to the payment of interest on deposits and the latter restricts transactions between a member bank and its officers and directors. It might be noted that the proposed amendment to Section 19 would give the Board a remedy comparable to that presently available to the Federal Deposit Insurance Corporation with respect to nonmember insured banks. The restrictions of Section 22(h), as amended by the proposed bill, and civil penalties for violations thereof, would be applied to nonmember insured banks by section 7 of the proposed bill.

A number of violations of various provisions of the Bank Holding Company Act have come to the attention of the Board of Governors in recent years. Some of these violations have been deemed willful and serious enough to be referred to the Department of Justice for prosecution under section 8 of the Bank Holding Company Act. Such referral is the Board's only statutory remedy at present when it finds such a violation.

To date, one referral has resulted in a conviction and a substantial fine. However, it is the Board's experience that the criminal remedy is an involved and lengthy process. In the case of the conviction, over two years elapsed between the time the violation came to the Board's attention and the ultimate conviction.

The Board therefore recommends in section 5 that it be given the discretion to impose civil penalties for violations of the Bank Holding Company Act. It believes that the addition of this alternative method of imposing penalties for violations of the Act will provide a significant deterrent effect.

In addition to the above recommendations relating to penalties designed to have a deterrent effect, the regulatory agencies believe that further substantive restrictions should be placed on transactions between banks and insiders. In this regard, it does not appear sensible to have a prohibition regulating only loans to officers of a bank and not loans to directors, stockholders, and corporations affiliated with such individuals.

We therefore recommend, as a preventative measure, that Section 22 of the Federal Reserve Act be amended to cover officers, directors, and individuals holding more than 5 per cent of the voting securities of a member bank and any companies controlled by such an officer, director, or 5 per cent shareholder. These restrictions should also be applied to nonmember insured banks. This proposal, which is set forth in sections 3 and 7 of the bill, would aggregate the loans or extensions of credit to such an officer, director, or shareholder and to all companies controlled by such an officer, director, or shareholder and provide that the aggregate may not exceed the limit on loans to one borrower established by federal or State law.

This legislation is premised on the concern, borne out by some recent experiences, that a bank may incur excessive risks by making large loans to insiders and their related business enterprises. We believe that in some instances the existence of lending limits, as well as civil penalties for their violation, may well prevent some problem bank situations from arising.

In addition to the above measures aimed at preventing problem bank situations, the bill includes two proposals designed to help deal with a problem bank situation once it exists. The first of these involves a proposed amendment to the Financial Institutions Supervisory Act of 1966 relating to removal proceedings. Under present law (Section 8(e) of the Federal Deposit Insurance Act), a bank director or officer who has engaged in a violation of a law, rule, or regulation, participated in an unsafe or unsound practice, breached his fiduciary duty, or violated a final cease and desist order and whose action is seen as causing substantial financial loss to the bank or damage to its depositors, may be removed only where it is shown that he has engaged in an act amounting to personal dishonesty. Such a showing is often difficult to make, and the present law thus effectively bars removal of individuals who have repeatedly demonstrated gross negligence in the operation or management of a bank, or a willful disregard for the safety and soundness of the bank, but who cannot be shown to have exhibited personal dishonesty.

We believe that adequate protection of the bank, its depositors, and the public interest requires the Act to be amended to allow the appropriate supervisory agency to remove such individuals. The amendments contained in section 6(d) of the bill would effectuate this proposal. We believe that the present hearing and judicial review requirements of the Act are sufficient to shield those who are innocent of personal wrongdoing from arbitrary or capricious administrative action. However, the proposed amendment would help to protect the financial safety of institutions against the actions of reckless individuals.

In addition, it appears that more efficient and speedy enforcement of final orders and consent agreements under the Financial Institutions Supervisory Act of 1966 can be obtained if civil penalties attach to violations of such final orders and agreements. Section 6(e) of the proposed bill embodies this recommendation and, we believe, would constitute a more effective deterrent than the present procedure, which requires the appropriate agency to apply to the U.S. district court to secure enforcement.

It appears to both the Board of Governors and the Comptroller of the Currency that a needless procedural complication presently exists in the Financial Institutions Supervisory Act of 1966. Section 8(e) of the Federal Deposit Insurance Act provides that in order to institute removal proceedings against a director or officer of a national bank the Comptroller must certify the facts to the Board of Governors, which determines, with the Comptroller sitting as a member of the Board of Governors, whether or not to institute proceedings. Following such proceedings, the matter comes before the Board once more for final action, again, with the Comptroller sitting as a member of the Board of Governors. This procedure appears to be unnecessarily duplicative. All of the procedural safeguards and advantages of having a board rather than an individual make the decision can be retained by providing for certification of the recommendations of the hearing officer to the Board of Governors for final action but allowing the Comptroller's office to institute and prosecute the proceeding. The bill in section 6(d) would obtain this result and thus increase the efficiency of the process.

The Federal Deposit Insurance Corporation has previously introduced legislation that would amend Sections 8(b) and 8(c) of the Federal Deposit Insurance Act to make it clear that cease and desist proceedings may be instituted against directors, officers, employees, and agents or other persons participating in the conduct of the affairs of a bank, regardless of whether or not the bank itself is named in the proceeding. This provision is supported by the other agencies and is found in section 6(a) and (c) of the proposed bill. The amendment further makes it clear that the Board of Governors has similar powers with respect to bank holding companies and their officers, directors, employees, and agents.

Additionally, section 6(b) of the proposed bill recommends a technical amendment to Section 8(b)(3) of the Federal Deposit Insurance Act, as amended, to make it clear that cease and desist proceedings may be instituted against Edge and Agreement Corporations whether or not those institutions are subsidiaries of holding companies.

The proposed bill includes in section 4 a provision designed to aid the Board of Governors in handling a problem bank situation where adverse effects have arisen from the relationship between the banking and nonbanking subsidiaries of the parent holding company. The Board's experience has been that problems and unfavorable publicity connected with a nonbanking susbidiary of a bank holding company may have an adverse impact on banks within the bank holding company and may lead to serious difficulties for such banks. Further, the Board believes, as it has often stated, that a bank holding company should be a source of financial strength for its subsidiary banks. In this regard, nonbanking subsidiaries within a bank holding company structure should augment rather than detract from that strength. For this reason, the Board believes it should have the power to order divestiture of a bank holding company subsidiary or termination of a nonbanking activity by a bank holding company whenever it has reasonable cause to believe that the continuation of such activity or ownership constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company's subsidiary bank[s].

The proposed legislation would give the Board such power, after providing the parent holding company with due notice and opportunity for a hearing. The amendment provides that the divestiture may be by sale or by pro rata distribution to the shareholders of the bank holding company. A relatively short period is provided within which such divestiture must be carried out in order to assure that the activity threatening the bank is terminated as rapidly as possible.

The Board recognizes that this power to order divestiture represents a drastic remedy and contemplates that it would be exercised only in very rare instances. However, the Board's experience to date leads it to believe that in some instances this remedy should be available in order effectively to protect the interests of a banking subsidiary of the bank holding company, its depositors, and customers.

In addition to the proposals contained in this bill, recent experience has convinced us that the definition of affiliate in the National Bank Act should be expanded to cover a greater range of relationships that would then be subject to the limitations on loans contained in Section 23A of the Federal Reserve Act. Such changes could be a major factor in curbing abuses by insiders. Conversely, experience has also led us to believe that in the case of banking affiliates that are subsidiaries of the same holding company, the restrictions of Section 23A may be counterproductive and may prevent the holding company from using its resources as effectively as a branching system. The agencies are presently working on a draft bill that will address itself to these issues and we expect to forward it for consideration in the near future.

We believe that adoption of the proposed bill would help to decrease the incidence of problem bank situations and significantly aid each of our agencies in our ability to require corrective action in problem bank situations. We therefore hope that Congress will act favorably on the recommendations.

Sincerely yours,

Arthur F. Burns

Enclosure

A BILL

To strengthen the supervisory authority of the Federal banking agencies over financial institutions and their affiliates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That:

AMENDMENTS TO THE FEDERAL RESERVE ACT

Section 1. The Federal Reserve Act (38 Stat. 251, as amended) is amended by redesignating Sections 29 and 30 as Sections 30 and 31 respectively and by adding a new Section 29 to read as follows:

> "SEC. 29. Any member bank which violates and/or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such member bank who violates any provision of Section 22 or 23A of this Act, or any lawful regulation issued pursuant thereto, shall forfeit and pay a civil penalty of not more than $1,000 per day for each day during which such violation continues. The Board shall have authority to assess such a civil penalty, giving due consideration to the appropriateness of the penalty with respect to the size or financial resources and good faith of the member bank or person charged, the gravity of the violation, and the history of previous violations. When assessed, such a civil penalty may be collected, by suit or otherwise, by the Board or the Federal Reserve Bank of the district in which such member bank is located. As used in this section, the term 'violates' includes without limitation any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation."

Section 2. Section 19 of the Federal Reserve Act, as amended (12 U.S.C. § 461), is amended by adding at the end thereof the following new subsection:

"(l) Any member bank which violates any provision of this section, or any regulation or order issued by the Board pursuant thereto, shall forfeit and pay a civil penalty not exceeding $100 per day for each day during which such violation continues. The Board shall have authority to assess such a civil penalty, giving due consideration to the appropriateness of the penalty with respect to the size or financial resources and good faith of the member bank charged, the gravity of the violation, and the history of previous violations. When assessed, such a civil penalty may be collected, by suit or otherwise, by the Board or the Federal Reserve Bank of the district in which such member bank is located."

Section 3. Section 22 of the Federal Reserve Act, as amended (12 U.S.C. §§ 375, 375a, 376 and 503), is amended by adding at the end thereof the following new subsection:

"(h)(1) No member bank shall make any loan or extension of credit in any manner to any of its officers or directors or to any individual who directly or indirectly or acting through or in concert with one or more persons owns, controls or has the power to vote more than 5 per centum of any class of voting securities of said member bank or to any company controlled by such an officer, director or individual, where such loan or extension of credit when aggregated and combined with all the bank's loans or extensions of credit to such officer, director or individual and to all companies controlled by such officer, director or individual, exceeds the limits on loans to one borrower established by Section 5200 of the Revised Statutes, as amended, in the case of national banking associations, or by the State law applicable in the case of State member banks.

"(2) For purposes of this section, an officer, director or individual shall be considered to have control of a company if said officer, director or individual:

"(A) directly or indirectly or acting through or in concert with one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the company; or

"(B) controls in any manner the election of a majority of the directors of the company; or

"(C) has the power, directly or indirectly, to exercise a controlling influence over the management or policies of such company.

"(3) For the purposes of this section, 'company' means any corporation, partnership, business trust, association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, any other form of business entity not specifically listed herein, or any other trust, but shall not include any insured bank or any corporation the majority of the shares of which are owned by the United States or by any State. 'Extension of credit' shall have the meaning assigned such term in the fourth paragraph of Section 23A of this Act."

AMENDMENTS TO THE BANK HOLDING COMPANY ACT OF 1956

Section 4. Section 5 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1844), is amended by adding at the end thereof the following new subsection:

"(e)(1) Notwithstanding any other provision of this Act, the Board may, whenever it has reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its subsidiaries constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company's subsidiary bank[s] and is inconsistent with sound banking principles or with the purposes of this Act or with the

Financial Institutions Supervisory Act, order the bank holding company or any of its subsidiaries, after due notice and opportunity for hearing, to terminate such activities or to terminate (within 120 days) its ownership or control of any such subsidiary either by sale or by distribution of the shares of the subsidiary to the shareholders of the bank holding company. Such distribution shall be _pro rata_ with respect to all of the shareholders of the distributing bank holding company, and the holding company shall not make any charge to its shareholders arising out of such a distribution.

"(2) The Board may in its discretion apply to the United States district court within the jurisdiction of which the principal office of the holding company is located, for the enforcement of any effective and outstanding order issued under this section, and such court shall have jurisdiction and power to order and require compliance therewith, but except as provided in Section 9 of this Act, no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under this section, or to review, modify, suspend, terminate, or set aside any such notice or order."

Section 5. Section 8 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1847), is amended by redesignating "Sec. 8" as "Sec. 8(a)" and by adding a new subsection (b) to read as follows:

"(b) Any company which violates or any individual who participates in a violation of any provision of this Act, or any regulation or order issued pursuant thereto, shall forfeit and pay a civil penalty of not more than $1,000 per day for each day during which such violation continues. The Board shall have authority to assess such a civil penalty, giving due consideration to the appropriateness of the penalty with respect to the size or financial resources and good faith of the company or individual charged, the gravity of the violation, and the history of previous violations. When assessed, such a civil penalty may be collected, by suit or otherwise, by the Board or the Federal Reserve Bank of the district in which such company is located."

AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

Section 6. (a) Section 8(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)(1)) is amended to read as follows:

"(b)(1) If, in the opinion of the appropriate Federal banking agency, any insured bank, bank which has insured deposits or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank is engaging or has engaged, or the agency has reasonable cause to believe that the bank or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank is about to engage, in an unsafe or unsound practice in conducting the business of such bank, or is violating or has violated, or the agency has reasonable cause to believe that the bank or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank is about to violate, a law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the bank, or any written agreement entered into with the agency, the agency may issue and serve upon the bank and/or such director, officer, employee, agent, or other person a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices, and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the bank and/or the director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after service of such notice unless an earlier or a later date is set by the agency at the request of any party so served. Unless the party or parties so served shall appear at the hearing by a duly authorized representative, they shall be deemed to have consented to the issuance of the cease-and-desist order. In the event of such consent, or if upon the record made at any such hearing, the agency shall find that any violation or unsafe or unsound practice specified in the notice of charges has been established, the agency may issue and serve upon the bank and/or the director, officer, employee, agent or other person participating in the conduct of the affairs of such bank an order to cease and desist from any such violation or practice. Such order may, by provisions which may be mandatory or otherwise, require the bank and/or its directors, officers, employees, agents and other persons participating in the conduct of the affairs of such bank to cease and desist from the same, and, further, to take affirmative action to correct the conditions resulting from any such violation or practice."

(b) Section 8(b)(3) of the Federal Deposit Insurance Act, as amended (12 U.S.C. § 1818(b)(3)), is amended: (1) by inserting after "Bank Holding Company Act of 1956" a comma and the following: "and to any organization organized and operating under Section 25A of the Federal Reserve Act or operating under Section 25 of the Federal Reserve Act,"; and (2) by adding at the end thereof the following new sentence:

"Nothing in this subsection or in subsection (c) of this section shall authorize any Federal banking agency, other than the Board of Governors of the Federal Reserve System, to issue a notice of charges or cease and desist order against a bank holding company or any subsidiary thereof (other than a bank or subsidiary of that bank)."

(c) Section 8(c)(1) and (2) of the Federal Deposit Insurance Act (12 U.S.C. 1818(c)(1) and (2)) are amended to read as follows:

"(c)(1) Whenever the appropriate Federal banking agency shall determine that the violation or threatened violation or the unsafe or unsound practice or practices, specified in the notice of charges served upon the bank or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank pursuant to paragraph (1) of subsection (b) of this section, or the continuation thereof, is likely to cause insolvency or substantial dissipation of assets or earnings of the bank, or is likely to otherwise seriously prejudice the interests of its depositors, the agency may issue a temporary order requiring the bank and/or such director, officer, employee, agent, or other person to cease and desist from any such violation or practice. Such order shall become effective upon service upon the bank and/or such director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank and, unless set aside, limited, or suspended by a court in proceedings authorized by paragraph (2) of this subsection, shall remain effective and enforceable pending the completion of the administrative proceedings pursuant to such notice and until such time as the agency shall dismiss the charges specified in such notice, or if a cease-and-desist order is issued against the bank and/or such director, officer, employee, agent, or other person, until the effective date of such order.

"(2) Within ten days after the bank concerned or any director, officer, employee, agent, or other person participating in the conduct of the affiars of such bank has been served with a temporary cease-and-desist order, the bank and/or such director, officer, employee, agent, or other person may apply to the United States district court for the judicial district in which the home office of the bank is located, or the United States District Court for the District of Columbia, for an injunction setting aside, limiting, or suspending the enforcement, operation, or effectiveness of such order pending the completion of the administrative proceedings pursuant to the notice of charges served upon the bank and/or such director, officer, employee, agent, or other person under paragraph (1) of subsection (b) of this section, and such court shall have jurisdiction to issue such injunction."

(d) Section 8(e) of the Federal Deposit Insurance Act, as amended (12 U.S.C. § 1818(e)), is amended to read as follows:

"(e)(1) Whenever, in the opinion of the appropriate Federal banking agency, any director or officer of an insured bank has committed any violation of law, rule, or regulation or of a cease-and-desist order which has become final, or has engaged or participated in any unsafe or unsound practice in connection with the bank, or has committed or engaged in any act, omission, or practice which constitutes a breach of his fiduciary duty as such director or officer, and the agency determines that the bank has suffered or will probably suffer substantial financial loss or other damage or that the interests of its depositors could be seriously prejudiced by reason of such violation or practice or breach of fiduciary duty, and that such violation or practice or breach of fiduciary duty is either one involving personal dishonesty on the part of such director or officer, or one which demonstrates his gross negligence in the operation or management of the bank or a willful disregard for the safety or soundness of the bank, the agency may serve upon such director or officer a written notice of its intention to remove him from office."

Paragraph (e)(2) is repealed.

Paragraph (e)(3) is redesignated as paragraph (e)(2) and is amended to read as follows:

"(e)(2) Whenever, in the opinion of the appropriate Federal banking agency, any director or officer of an insured bank, by conduct or practice with respect to another insured bank or other business institution which resulted in substantial financial loss or other damage, has evidenced either his personal dishonesty or his gross negligence in the operation or management of the bank or institution or a willful disregard for its safety and soundness, and, in addition, has evidenced his unfitness to continue as a director or officer and, whenever, in the opinion of the appropriate Federal banking agency, any other person participating in the conduct of the affairs of an insured bank, by conduct or practice with respect to such bank or other insured bank or other business institution which resulted in substantial financial loss or other damage, has evidenced either his personal dishonesty or his gross negligence in the operation or management of the bank or institution or a willful disregard for its safety and soundness, and in addition, has evidenced his unfitness to participate in the conduct of the affairs of such insured bank, the agency may serve upon such director, officer, or other person a written notice of its intention to remove him from office and/or to prohibit his further participation in any manner in the conduct of the affairs of the bank."

Paragraph (e)(4) is repealed.

Paragraph (e)(5) is redesignated as paragraph (e)(3) and is amended to read as follows:

"(e)(3) In respect to any director or officer of an insured bank or any other person referred to in paragraph (1) or (2) of this subsection, the appropriate Federal banking agency may, if it deems it necessary for the protection of the bank or the interests of its depositors, by written notice to such effect served upon such director, officer, or other person, suspend him from office and/or prohibit him from further participation in any manner in the conduct of the affairs of the bank. Such suspension and/or prohibition shall become effective upon service of such notice and, unless stayed by a court in proceedings authorized by subsection (f) of this section, shall remain in effect pending the completion of the administrative proceedings pursuant to the notice served under paragraph (1) or (2) of this subsection and until such time as the agency shall dismiss the charges specified in such notice, or, if an order of removal and/or prohibition is issued against the director or officer or other person, until the effective date of any such order. Copies of any such notice shall also be served upon the bank of which he is a director or officer or in the conduct of whose affairs he has participated."

Paragraph (e)(6) is repealed.

Paragraph (e)(7) is repealed.

Paragraph (e)(8) is redesignated as Paragraph (e)(4) and is amended to read as follows:

"(e)(4) A notice of intention to remove a director, officer, or other person from office and/or to prohibit his participation in the conduct of the affairs of an insured bank, shall contain a statement of the facts constituting grounds therefor, and shall fix a time and place at which a hearing will be held thereon. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after the date of service of such notice, unless an earlier or a later date is set by the agency at the request of (A) such director or officer or other person, and for good cause shown, or (B) the Attorney General of the United States. Unless such director, officer, or other person shall appear at the hearing in person or by a duly authorized representative, he shall be deemed to have consented to the issuance of an order of such removal and/or prohibition. In the event of such consent, or if upon the record made at any such hearing the agency shall find that any of the grounds specified in such notice has been established, the agency may issue such orders of suspension or removal from office, and/or prohibition from participation in the conduct of the affairs of the bank, as it may deem appropriate. In any action brought under this section by the Comptroller of the Currency in respect to any director, officer or other person with respect to a national banking association or a District bank, the findings and conclusions of the Administrative Law Judge shall be certified to the Board of Governors of the Federal Reserve System for the determination of whether any order shall issue. Any such order shall become effective at the expiration of thirty days after service upon such bank and the director, officer, or other person concerned (except in the case of an order issued upon consent, which shall become effective at the time specified therein). Such order shall remain effective and enforceable except to such extent as it is stayed, modified, terminated, or set aside by action of the agency or a reviewing court."

(e) Section 8(i) of the Federal Deposit Insurance Act, as amended (12 U.S.C. § 1818(i)), is amended by redesignating subsection 8(i) as 8(i)(1) and by adding a new subsection 8(i)(2) to read as follows:

> "8(i)(2) Any insured bank which violates and/or any officer, director, employee, agent or other person participating in the conduct of the affairs of such a bank who violates the terms of any order which has become final and was issued pursuant to subsections (b) or (c) of this section, shall forfeit and pay a civil penalty of not more than $10,000 per day for each day during which such violation continues. The appropriate Federal banking agency shall have authority to assess such a civil penalty, giving due consideration to the appropriateness of the penalty with respect to the size or financial resources of the bank or person charged. When assessed, such a civil penalty may be collected by the appropriate Federal banking agency by suit or otherwise."

Section 7. Section 18(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. § 1828(j)), is amended by redesignating section 18(j) as "18(j)(1)" and by adding the following new subsections:

> "18(j)(2) The provisions of Section 22(h) of the Federal Reserve Act, as amended, relating to limits on loans and extensions of credit by a member bank to its officers or directors or to any individual who directly or indirectly owns, controls or has the power to vote more than 5 per centum of any class of voting securities of such member bank or to companies controlled by such an officer, director or individual, shall be applicable to every nonmember insured bank in the same manner and to the same extent as if such nonmember insured bank were a State member bank.
>
> "18(j)(3) Any nonmember insured bank which violates and/or any officer, director, employee, agent or other person participating in the conduct of the affairs of such nonmember insured bank who violates any provision of Section 23A or 22(h)

of the Federal Reserve Act, as amended, or any lawful regulation issued pursuant thereto, shall forfeit and pay a civil penalty of not more than $1,000 per day for each day during which such violation continues. The Corporation shall have authority to assess such a civil penalty, giving due consideration to the appropriateness of the penalty with respect to the size or financial resources and good faith of the nonmember insured bank or person charged, the gravity of the violation, and the history of previous violations. When assessed, such a civil penalty may be collected, by suit or otherwise, by the Corporation. As used in this section, the term 'violates' includes without limitation any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation."

Mr. ROSENTHAL. Thank you, Mr. Leavitt, for what I think is a very useful statement.

On appendix III, I notice that the banks under special surveillance, as of December 31, 1975, is 65 and is the highest it has been in 10 years.

Mr. LEAVITT. Yes; that is correct, Mr. Chairman.

Mr. ROSENTHAL. Could you briefly tell us why you think it is at its highest figure in 10 years?

Mr. LEAVITT. I think that it is at the highest level for two reasons: The excesses of the late sixties and early seventies and the economic recession. The coming together of these two factors resulted in banks having a relatively large number of troublesome assets.

Most of the banks that are contained on these lists for special surveillance have asset problems. They have a heavier than normal volume of classified assets.

Mr. ROSENTHAL. Do you have a rough notion of the figure of the total assets of those 65 banks?

Mr. LEAVITT. We have included that in appendix II, Mr. Chairman. It is not up to date because the data in appendix II come from examination reports. But you can note, by looking at 1974, that there were 45 banks with a 3 rating. The total deposits of those 45 banks in 1974 were approximately $52 billion.

Mr. ROSENTHAL. There were only four banks that had a 4 rating. What were their total deposits?

Mr. LEAVITT. Theirs were $117 million.

Mr. ROSENTHAL. You stated that there were two causes for these problems: The excesses of the sixties and seventies and the recession. What were these excesses?

Mr. LEAVITT. I think the committee should bear in mind here that we are really talking about two different groups of banks—the relatively large banks on the one hand and the relatively small banks on the other. The small banks, for the most part, have continued as they have historically continued. They do not have, for example, the ability.

Mr. ROSENTHAL. They were not necessarily guilty of the excesses, were they?

Mr. LEAVITT. They don't have the ability, really, to become guilty of the excesses. They are small and take the deposits of their local communities.

Mr. ROSENTHAL. Whatever the motivations, they did not indulge in the excesses that you are now going to describe.

Mr. LEAVITT. That is correct, sir. We are talking essentially about the larger banks—not just the huge banks, but the larger regional banks and the major banks.

Mr. ROSENTHAL. When you entertain this description, you are including not only the State banks that were under your jurisdiction, but the national banks that were under the jurisdiction of the Comptroller of the Currency, are you not?

Mr. LEAVITT. Yes, this is a general statement, Mr. Chairman, which is applicable to all of the banking systems.

The excesses that I am describing principally resulted, I think, from the phenomenon described as "liability management." Under the concept of liability management, for example, a bank can contract or agree to make certain loans; and if called upon to honor that commitment to make these certain loans, it goes into the market and acquires the liability. It purchases the deposits in order to have the funds available to lend to the individual or to the company.

This rapid expansion resulted in increasing both sides of the balance sheet. The one side which was represented by such things as large denomination certificates of deposit, Federal funds purchased, and Eurodollars is offset on the other side by more loans. They expanded rapidly. Now that was the expansion, Mr. Chairman.

Mr. ROSENTHAL. Is that what Governor Bucher described as "go-go" banking?

Mr. LEAVITT. Yes; I think that is fair but it is also a matter of degree. I assume Governor Bucher meant when carried to extremes.

Mr. ROSENTHAL. And the situation apparently has not been corrected because as of 1975 you had the highest number of banks on the number 3 list.

Mr. LEAVITT. This was the result of the expansion of which I spoke, and the economic recession, which was the deepest recession that the country has had since the Great Depression of the 1930's. The coming together of the two resulted in well-publicized problems of the banks with the REIT loans, for example. Much has been written about them. Also there were other real estate oriented credits.

Mr. ROSENTHAL. The point I am trying to understand, Mr. Leavitt, is: If these excesses were indulged in by banks, were you regulators in a position to do anything about it? Could you have restrained it?

Mr. LEAVITT. What subsequently looks like an excess does not at the beginning of any phenomenon, of course, take on that hue. Whenever an economy or an individual is engaging in some sort of activity, it initially looks just like something little. But then it grows. I think it is after the fact that you characterize it as an excess. This may sometimes happen later, but certainly not at the beginning.

Mr. ROSENTHAL. Is it your testimony that you are unable to perceive it or understand it as a growth phenomena?

Mr. LEAVITT. I don't think you can at the beginning of any cycle, Mr. Chairman. For example, what might later be called an excess is, at the first blush—and a goodly portion of it still is—the appropriate reaction of the banks and other lenders to satisfy the needs of the American economy.

Mr. ROSENTHAL. Do you today think the regulators did a good, fair, or poor job during this period of time?

Mr. LEAVITT. I think that the regulators during this time did at least a fair job, Mr. Chairman.

Mr. ROSENTHAL. Did you read Mr. Smith's statement in one of this morning's metropolitan New York newspapers?

Mr. LEAVITT. I was handed that statement as I got into the car.

Mr. ROSENTHAL. So you haven't read it yet?

Mr. LEAVITT. I skimmed through it as I was coming over.

Mr. ROSENTHAL. You say on page 2 of your testimony that—

> . . . the underlying cause of the weaknessses that became apparent in the recent recession can, to a significant extent, be traced to the general economic and financial excesses of the early 1970's.

Yet on appendixes II and III, it appears that precisely when the excesses were taking place in the early 1970's, the number of banks noted as deserving special attention was declining. It would seem to me that if the examination process were functioning as it should have been, the number of banks designated as problem banks would have been increasing during those years rather than declining.

Mr. LEAVITT. No; I don't think so, Mr. Chairman. This was the beginning of a cycle. They were adding then to both sides of the balance sheet. They were increasing the liabilities by purchasing funds to make loans. And one must place himself in the position of the economy at that time. Remember, the real estate industry was booming and everything was booming. They went out to make the loans. Nobody ever intentionally made a bad loan.

Mr. ROSENTHAL. Is it your testimony today that you regulators are not in a position to know the excesses have occurred in totality until the cycle has been completed?

Mr. LEAVITT. I wouldn't want to go so far as to say until the cycle has been completed. During this cycle, I think that the things the Board did in 1973—and to which I refer on pages 3 and 4 of the testimony—and other actions that were taken indicated that the Federal Reserve System was clearly aware that there were excesses. This was as early as April and May of 1973.

Mr. ROSENTHAL. But there are more banks on the problem list today than when you sent out the Burns letter in April of 1973.

Mr. LEAVITT. There are because the loan problems do not become apparent until a little bit later. By its nature, moreover, the examination process has to lag a bit after the fact.

Mr. ROSENTHAL. How far?

Mr. LEAVITT. At the time that a banker makes a loan he thinks the loan is sound and expects to get his money back with little trouble. If he anticipated trouble, he wouldn't make the loan. No lenders make money if they don't get back their loans and interest with a minimum of trouble.

Mr. ROSENTHAL. But some are bigger and better gamblers than others.

Mr. LEAVITT. Most lenders, banks and otherwise, want to get their money back. Now I think that banks take into account any risk that might be apparent. There is always risk. But in some cases, they knowingly accept the degree of risk.

Mr. ROSENTHAL. Were the people on your list of 65 as of December of 1975 larger risk takers than others? Were they less prudent? Did they have less judgment? Were they less sophisticated? Were they less mature? What about them was different from the banks that don't make the problem list?

Mr. LEAVITT. Several things were probably different. They perhaps took a few more risks. They perhaps did not service as aggressively as some of the other banks. Perhaps many of the banks that are off the list were by nature the more conservative institutions. Some banks are more conservative than others. There are times when perhaps the banks that are less conservative serve a very real purpose by financing the American industries.

Mr. ROSENTHAL. I am trying to create a simple record. I don't understand why you have more banks today on the problem list than you had 10 years ago when you have been working on this project for years now. Your own testimony indicates that Mr. Burns started these warnings in April of 1973.

Mr. LEAVITT. That's right.

Mr. ROSENTHAL. But the warnings have been totally ineffective.

Mr. LEAVITT. No, Mr. Chairman; they have not been totally ineffective.

Mr. ROSENTHAL. Do you mean that if they were ineffective we would have 165 instead of 65?

Mr. LEAVITT. That is possibly so.

Mr. ROSENTHAL. Your record of performance does not look very good to me. I must be missing something.

Mr. LEAVITT. I agree to some extent with the statement that if it were not for the efforts to supervise as aggressively as we could, given the circumstances, there would have been more banks on the problem list. Had it not been that we talked with these banks, that we were aware of their plans, that they were aware of our plans, and that we were asking them for additional capital during this period of time, there might well have been more banks on the list.

Mr. ROSENTHAL. You are the chief regulator. Right? You are the Director of the Division of Supervision and Regulation. Do you take comfort in the fact that you had the highest number of banks on the problem list to date as of today?

Mr. LEAVITT. No, I don't take comfort from that. What I do take from that, Mr. Chairman, is that I must try as vigorously as possible to reduce the number. That is what I try. I don't take comfort in it.

Mr. ROSENTHAL. How are you going to do that?

Mr. LEAVITT. We do it in several ways, Mr. Chairman. The Federal Reserve has at the Reserve bank level an officer in charge of examination. They have immediate field contact, do the examinations, write many of the letters, and have the meetings with the bank and with the bank's board of directors who are looking toward an improvement in the condition or working out programs that will result in some kind of an improvement in the condition.

Mr. ROSENTHAL. Let's take a specific case. On July 17, 1972, you received a letter from Mr. Arthur Roth, the former chief executive officer of Franklin National Bank. I am sure you recall that.

Mr. LEAVITT. I recall Mr. Roth. I have seen the letter recently, although I did not recall the letter at that time. I don't believe I saw the letter.

Mr. ROSENTHAL. Do you recall Mr. Roth's sending out signals to the Board that Franklin was in trouble and that there was a deteriorating condition going on?

Mr. LEAVITT. No; I don't. I cannot recall specifically that Mr. Roth did this. Now I know in fact, Mr. Chairman, that he sent the letter because when this came up, we naturally looked it up. We have such a letter exactly as Mr. Roth represented to you in the files of the Board.

Mr. ROSENTHAL. He is prepared to testify under oath that he did all of these things. I want you to know that.

Mr. LEAVITT. That he sent the letter?

Mr. ROSENTHAL. Yes.

Mr. LEAVITT. Oh, yes; we have it.

Mr. ROSENTHAL. The letter contained warnings about what was happening to Franklin. I would like to know what you did about it.

Mr. LEAVITT. If I may, sir, I was addressing myself to what I thought was your more narrow question of, did I know that it was in the files. I do not, to the best of my recollection, remember that.

I must be somewhat circumspect in my answer because the System is involved in certain litigation involving the Franklin New York Corp. and the Franklin National Bank.

At the time that letter was received in April of 1972, I believe, the Franklin New York Corp., which was a holding company that owned the Franklin National Bank, was essentially a shell corporation. It had no other banks other than the Franklin; it had none of the nonbanking activities. That holding company went back to prior to the 1970 amendments when it was originally approved. At that time, and in view of the fact that it was essentially a shell corporation, we were looking principally to the primary supervisor, the Comptroller of the Currency, since this was a nationally chartered bank.

Now the first time that the Board really had regulatory power in this particular area was when the Franklin New York Corp. applied to acquire the Talcott Co. That application was made in the latter part of 1973 and was subsequently denied.

Mr. ROSENTHAL. Why did you deny it?

Mr. LEAVITT. We denied the application, as the Board's order stated, because of the impact upon earnings of the corporation. As nearly as I remember, that was the narrow reason given for it.

Mr. ROSENTHAL. Was the Board satisfied with the supervision and conduct of the Comptroller of the Currency with regard to Franklin?

Mr. LEAVITT. I would like to answer in this way, Mr. Chairman. When the application was filed, I and other members of the Federal Reserve System discussed the applicant and the condition of the subsidiary applicant. As a result of those discussions, the applicant did inject additional capital into the bank in the amount of $30 million. They did, as I recall, convert some debt capital into equity capital. They were taking steps to effect economies in the operation by cutting back on expenses. They were doing everything we were discussing in these various areas which were designed to improve the condition of the Franklin National Bank.

Mr. ROSENTHAL. Should the Comptroller of the Currency have initiated most of those recommendations?

Mr. LEAVITT. I have no reason to think that the Comptroller was not aggressively pursuing a policy of trying to effect corrections. You must remember, Mr. Chairman, that at that time they had filed the application with us. That is a significant leverage factor in our ability to effect some corrections.

Mr. ROSENTHAL. I have some other questions, but I want to pass to my colleagues. Mr. Erlenborn.

Mr. ERLENBORN. Thank you, Mr. Chairman. I have no questions.

Mr. ROSENTHAL. Congressman Drinan.

Mr. DRINAN. Thank you, Mr. Chairman.

For banks in category 3, Mr. Leavitt, you indicate that this ". . . could reasonably develop into a situation urgently requiring aid either from the shareholders or otherwise." In view of that, do you think that the shareholders have some right to know how the bank is rated?

If this were a public corporation, the SEC would make that information known. How do you feel about the practice of depriving the shareholders and the depositors of this key information?

Mr. LEAVITT. Your question, Congressman Drinan, goes to the shareholders and the depositors as contrasted to director shareholders. I think this is the thrust of your query.

The supervisory examination function works very well because of a longstanding relationship between the bank examiners and the banks. It is for a purpose somewhat different than is the disclosure of normal information for the aid of stockholders.

For the aid of stockholders, there is disclosure. Now we are talking essentially about bank holding companies and the larger banks that report to the Federal Reserve, and not the very small banks. But there is disclosure of information in amounts comparable to that disclosed by other corporations. Banks, as a matter of fact, probably disclose more information about their internal situation and about their well-being than do other organizations. They file four condition reports a year. They file annual reports with either the Securities and Exchange Commission, if they are subsidiaries of bank holding companies, or with the Federal Deposit Insurance Corporation, the Federal Reserve System, or the Comptroller of the Currency if they are banks having more than 500 stockholders. They file voluminous information, and we are asking them to file more information. Also, in these statements filed by the larger organizations, the statements are audited by an accounting firm.

Mr. DRINAN. What about the rating? Do you think that should be withheld forever?

Mr. LEAVITT. I have long thought so. I think that the regulators probably never really focused that carefully upon the rating per se. We told the banks and the banks' directors of significant problems. We did not tell them of the rating, but they were informed of any problems that existed.

Mr. DRINAN. You have said here that they generally respond to your suggestions. But how many banks remain, for example, in category 2 for the indefinite future? Are there some banks which are in category 2 for some various weakness which are going to be there for the foreseeable future?

Mr. LEAVITT. Banks in category 2, Congressman, in some ways may do a better job of servicing their communities than banks in category 1.

Mr. DRINAN. I know, sir, I can read. But would you answer the question. Are there banks that stay in category 2 for years and years with you people knowing it is a category 2 bank, but the public's never knowing?

Mr. LEAVITT. That is correct; there are banks that stay in category 2 for long periods of time for various reasons.

Mr. DRINAN. But the public never knows those reasons.

Mr. LEAVITT. That is correct; the public does not know those reasons.

Mr. DRINAN. What is the rationale for that? What is your agency for? Shouldn't the bank be given a warning or told that they have 90 days to correct the situation or have it made public? What is regulation all about?

Mr. LEAVITT. Regulation is an effort, Congressman Drinan, to effect corrections or improvements in the condition of banks. It has not been considered in the past that it was for the purpose of telling the public, but of protecting the public by effecting the correction without necessarily going to the public.

Mr. DRINAN. But now I take it by your silence that there are a large number of banks that remain in category 2 in perpetuity. This is known to you people. It is apparently impossible to bring them into category 1, but yet the public never knows that this group of banks is in category 2 and will remain there.

Mr. LEAVITT. Banks get in and out of the various categories—whether it be 1, 2, 3, or 4. They may stay there for a long period of time, but they may move from category 2 to category 1, or over to 3.

Mr. DRINAN. Suppose the Consumers Union came along and said, "We want to inform the public that category 1 is excellent; category 2 is okay; category 3 is deficient." And suppose they want to know the names of those banks. How would you respond to that?

Mr. LEAVITT. Mr. Congressman, I would have to say to the Consumers Union or whatever other group that if we were to adopt a proposal such as this, it must be remembered that we do not at this time have a program that would give this information to the public. To do this would clearly impact upon the ability of the examiners to have frank, open and free discussions with bank management, and to obtain from them all of the information that might be needed in order that we can fulfill our function.

Mr. DRINAN. They are required by law to give you everything that you need. I don't think that that washes. But what is so terrible about the public's wanting to know about their financial institutions?

Mr. LEAVITT. There is nothing terrible about the public's wanting to know.

Mr. DRINAN. Maybe under the Freedom of Information Act a public interest law firm could acquire that information. I would like to know what banks are in category 2.

Mr. LEAVITT. As I understand the Freedom of Information Act, there is a specific exemption in there for information that is obtained in the examination process of a bank.

Mr. DRINAN. Maybe that exemption should be repealed then.

Mr. LEAVITT. I hadn't thought so.

Mr. DRINAN. Did the Federal Reserve lobby have that in there when the bill went through?

Mr. LEAVITT. I honestly can't answer that. I don't remember, sir.

Mr. DRINAN. Do you think that the argument which you just made, that it is more comfortable for the examiners and for the bank officials if this information remains secret, is valid? Certainly it is easier but wouldn't it be better if some method was developed to bring out these categories? Apparently you do not think so.

Mr. LEAVITT. No; I don't.

Mr. DRINAN. Would you describe the "go slow" policy which you mentioned on page 4? Is that policy still in effect?

Mr. LEAVITT. The "go slow" policy was mentioned on page 4 traces back to the middle of 1974. It was a manifestation of the System's concern about the trend of the banking industry at that time. The "go slow" policy, simply stated, evidences to the banking industry that they should look carefully at their proposals to expand and that their expansion should be minimal. It is not a "stop" policy; it is a "go slow";

a "take-it-easy" policy—expand minimally. And when you do expand, it should not require too much of an outlay of capital funds. Take it easy, watch where you are going, don't stop; but watch where you are going.

This was signaled to the industry by some Board decisions, publicly announced in the summer of 1974, denying certain applications. In connection with those denials, the Board stated publicly that the affected companies should use their resources, managerial and capital, to look at the problems that they had and to shore up their capital structures. The policy remains in effect to a degree.

Mr. DRINAN. Do you think that the Federal Reserve itself has been consistently following that policy in the approvals that it has given to new acquisitions by holding companies?

Mr. LEAVITT. I think it has. As I have said, the policy is not a "stop" policy. The policy is "go slow." And it was, of course, concerned with activities to clearly expand. Certain activities in which holding companies engage are not very expansionary. The underwriting of credit life insurance, data processing, and certain others are not very expansionary—those, we have not stopped.

The Board has also not seen fit to stop bank holding companies from establishing de novo offices in their consumer finance companies and their mortgage banking companies. They are normally established in new areas and that provides another source of service for the consumer. It also provides additional competition. So the Board has not seen fit to stop that. But the major acquisitions have been very rare over the past few years.

Mr. DRINAN. Thank you very much. I yield back to the chairman.

Mr. ROSENTHAL. Mr. Evans.

Mr. EVANS. In rating banks, do you distribute the No. 1 through No. 4 rating on a bell curve, or how do you distribute those ratings?

Mr. LEAVITT. We do not, Congressman Evans. Attached to my statement as appendix I is an explanation of how we rate banks, and under this there is no bell curve. Every bank could be a 1 or 2 or whatever it is. These are mathematical to some extent and subjective to some extent, but there is no curve.

Mr. EVANS. Can you explain to me why these figures in appendix II on the ratings of the State member banks appear to remain so stable over time?

Mr. LEAVITT. It is not by design, nor is it by intent. It is the way in which our application of the rating system results. It is the way they fall. I hadn't thought of this question before, in all honesty.

Mr. EVANS. You would have no explanation then as to why that might be so?

Mr. LEAVITT. No; except that it is not by design. We have no bell curve or grading curve, as it were.

Mr. EVANS. On page 7 of your testimony, you referred to the heavy reliance on liability management. Could you explain to me what you mean by the term "heavy"?

Mr. LEAVITT. The practice of liability management is something that is done by large banks. Heavy reliance is difficult to explain. In the first place, the concept of liability management deals with how far any given bank should go in the practice of liability management. It is something that an individual bank probably has to determine for itself.

We are talking about large institutions. Large institutions can access the money market in a variety of ways. They can sell their big CD's; they can purchase Federal funds; they can acquire Eurodollars; they can sell securities under repurchase agreements. Presumably, therefore, they have some overall short-term borrowing capacity. The big banks watch this carefully and know the level of their borrowing capacity. They know what can be gotten from these various sources. Now there is a degree of subjectivity in this. You cannot reduce this to a clear mathematical formula, but they should know that they can get so many dollars from these markets with no difficulty.

Then, in my view, they should take only a portion of that and leave themselves a significant margin in order that they are not operating too close.

It must be remembered that there has been a significant change in the composition of liabilities of banks over the last few years. Several years ago banks had heavy volumes of demand deposits, which had to be paid on demand. As the corporate treasurers became more sophisticated and interest rates went up, the corporate treasurers, instead of putting those deposits in banks on demand where they were not making any money, converted those to large denomination certificates of deposit. So banks have to look at this. They have to look at the sources of funds.

One further factor in this reliance upon these funds is that banks watch carefully to see if the customers from whom they are obtaining these liabilities have some other business relationship with the bank. Rather than just going into the market and selling their certificates of deposit—which can be done—they say it is good to have some other relationship with the purchaser of certificates of deposit. That does not, of course, assure the bank that it can have the money, but it often gives them the right of first refusal. If they meet the interest rate, they will probably have the money at the time when that certificate comes due and must be renewed.

This is a complex area, Mr. Congressman.

Mr. EVANS. As it is a complex area, could you briefly explain again what is meant by the term "bootstrapping"?

Mr. LEAVITT. Bootstrapping is normally practiced in very small organizations. The holding company takes the stock of the bank that is owned and then goes to a bank or some other lender—it can be any lender—and pledges that stock or a portion of it and gets money. It then retires some of the stock of the holding company so that the holding company itself has less net worth and more debt. As a result of that, if they want to sell it, they don't have to put up as much money. The purchaser does not have to put up as much money because the owner of the holding company's stock, when he retired the stock of the holding company, got some of his money out from the proceeds of this loan.

Mr. EVANS. Could you tell me if any of the major bank holding companies engaged in "bootstrapping" last year?

Mr. LEAVITT. No. This is a phenomenon of the small companies, not the large companies. These are very small companies of a few million dollars—not billions, but a few million.

The large companies may from time to time buy some of their own stock. But this is normally for appropriate corporate needs such as stock options for management or perhaps for the exchanging of stock of some other company. Big companies do not engage in bootstrapping in the sense that it is used in this memorandum.

Mr. EVANS. Can you tell me what has been the percent and the dollar amount of the net variation in the Chase Manhattan Bank's and the First National City Bank's deposits since January 1 of this year?

Mr. LEAVITT. I really couldn't.

Mr. EVANS. Would it be possible to obtain that information?

Mr. LEAVITT. We can get our call report of condition at such time as they report their condition. They do that from quarter to quarter. That you can get. That is public information, Mr. Congressman.

Mr. EVANS. Can you briefly tell me what has happened to the prices of Chase Manhattan's and City Bank's stocks since January 12 of this year as a result of the first Washington Post article which discussed these banks' financial problems?

Mr. LEAVITT. I actually haven't looked lately, but I do know that shortly after the story it had not had a heavy impact upon the stock of these companies. I also think that the Keith Stock Index recently has shown that bank stock prices have increased some few percentages during the month of January. That is a recollection, sir.

Mr. EVANS. What about some other banks that were mentioned in a New York Times article on January 29, such as Chemical Bank, Manufacturers Hanover Trust, Marine Midland Bank, and Union Bank of Los Angeles? What has happened to the prices of their stock?

Mr. LEAVITT. To the best of my knowledge, they have not fluctuated very much.

Mr. EVANS. So you are saying that they have remained stable?

Mr. LEAVITT. Yes. They are perhaps down a little bit, but not significantly. Bank stock prices, for the most part, were not very high even prior to the issuance of these stories. Bank stocks had gone down a lot during the year of 1975.

Mr. EVANS. Would you comment then on the statement that these various facts and events really do not reflect a lack of confidence on the part of the public and the financial community in the financial conditions of these banks as a result of press disclosures?

Mr. LEAVITT. Following the release of the disclosure with respect to City Bank and the Chase Bank, you will recall that the Comptroller of the Currency issued a press release stating that the banks were sound in all respects. Following the release of my memorandum of March 5, 1975, recapping for the Board information that was based upon an earlier examination report, the Federal Reserve System issued a statement indicating that the Chase Bank, which was the only one to which that particular article referred, had responsible management and was a sound bank.

Mr. EVANS. So there hasn't been any run on these banks?

Mr. LEAVITT. There have been no runs.

Mr. EVANS. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Mr. Maguire.

Mr. MAGUIRE. Thank you, Mr. Chairman.

Mr. Leavitt, Dr. Burns has been quoted as saying that the current bank regulatory system is ". . . fostering a competition in laxity as regulators are played off against one another by banks with power to choose their regulators." I wonder if any State member banks have suggested to you that they might choose another regulatory agency rather than put themselves at the exposure of the Federal Reserve's closer scrutiny or recommended corrective actions in cases where the Federal Reserve might feel that those were called for? Is anybody deserting the ship?

Mr. LEAVITT. If they were deserting the ship, Mr. Maguire, I don't think they would put it into the terms that you have put it. They would not normally come to me and say that they were leaving to get out from under the tighter regulatory authority. The common reason given for banks leaving the Federal Reserve System is to escape the burden of carrying reserves with the Federal Reserve System. That is the reason given by virtually every bank that leaves.

Mr. MAGUIRE. That is the reason that I have heard expressed by them to me as well.

Mr. LEAVITT. That is the common reason, sir.

Mr. MAGUIRE. But I am wondering if, in your knowledge, there might be, from time-to-time, other reasons as well? Are there in fact other reasons that are cited or that you think sometimes motivate such a change?

Mr. LEAVITT. I really don't know what motivates them oftentimes. Sometimes they may be converting to Federal Reserve State member status because they think that we might grant them branches or something whereas under other conditions they might not get them.

Mr. MAGUIRE. Do you mean that they come to you for that purpose?

Mr. LEAVITT. I was citing that as a hypothetical reason, Mr. Maguire. I would really be hard pressed to say that any bank came to me and said, "We are leaving the Federal Reserve System because you are too mean."

Mr. MAGUIRE. What banks have in fact switched from Federal Reserve to national bank status since 1969?

Mr. LEAVITT. I would have to go back to get that. We could give you a tabulation of the ones that have, Mr. Maguire, if you would like. But I couldn't remember them.

Mr. MAGUIRE. Do you have a ball park idea of how many we might be talking about?

Mr. LEAVITT. I saw figures awhile back. I think those were appended to the testimony in the Fine study. Somewhere in the Fine study, there is a statement of switches.

Mr. MAGUIRE. Does that deal with reasons cited?

Mr. LEAVITT. No; I think that is merely a factual tabulation of the numbers. If you would like, we can provide that for you.

Mr. MAGUIRE. I would appreciate that.

Mr. ROSENTHAL. Without objection, that statement will be included in the record.

[The information referred to follows:]

CHANGES IN BANK CHARTERING AUTHORITY AND MEMBERSHIP STATUS, 1960–75

		Away from membership		Neutral as to membership		Toward membership	
	Total changes	State member to nonmember	National to nonmember	State member to national	National to State member	Nonmember to State member	Nonmember to national
1960	55	25	8	9		7	6
1961	28	14	1	4		5	4
1962	48	24	6	4		5	9
1963	65	22	13	8	1	4	17
1964	59	19	5	13	1	3	18
1965	51	22	7	11			11
1966	68	31	7	12	2	4	12
1967	37	21	5	4		1	6
1968	67	41	12	6		2	6
1969	88	42	24	6	3	3	10
1970	87	38	38	7			4
1971	54	20	20	3		4	7
1972	80	34	22	7	1	6	10
1973	70	27	21	8		3	11
1974	70	28	20	5		10	7
1975 [1]	41	20	8	3	1	4	5
Total	968	428	217	110	9	61	143

[1] Through September 1975.

Mr. MAGUIRE. The First Pennsylvania National Bank, presumably, was one such; was it not?

Mr. LEAVITT. It was one.

Mr. MAGUIRE. Do you happen to know anything about the adjusted capital to assets ratio of the First Pennsylvania National Bank at that time when they switched, and whether or not it required special scrutiny by your examiners?

Mr. LEAVITT. I have been told by the Board that I am not to discuss individual banks, Mr. Maguire.

Mr. MAGUIRE. One of the things that concerns me about the situation here, with reports in the papers about problem banks and the evidence that we seem to be developing here, is that the positions of many of the important banks, and others that are less important, seem to be weaker—at least relative to what it used to be—than many of us including yourself and other regulators, would prefer. This leads to a situation in which we may not be able, if the banks hunker down now, to count on the kind of capital that we would like to have flowing into areas where there might be some risk, but where it would be useful to have loans granted. I am thinking, for example, of such things as the preservation of communities in our central cities and small business loans which might be a little more risky than others.

How do you feel about this distortion that has apparently happened in which the risky money has been going not to such worthy recipients at a given level of risk; but, at the same level of risk, or perhaps even more risky, has been going to the real estate investment trusts and others? Here we are talking about loans which really do not strengthen our economic or social fabric, but which work in the opposite direction.

Would you comment on that? This is one of the concerns that I have had.

I want banks to be strong and I want them to be able to lend. But I want them to be able to lend intelligently. And I am confused as to why we are where we are today with these apparent distortions and the weakening of the banks positions. We are trying in these hearings to understand it all.

Mr. LEAVITT. It is correct, I think, that there are problems in the banking industry. They have been pretty well documented. You have named some of them with the REIT's and those types of loans.

I think, however, that the banking industry knows the extent of the problems, has a grasp on them, and is coming out of these problems even stronger.

The banking industry, I also believe, is anxious to improve capital. Now when we are talking here about the improvement of capital, we are thinking again of the larger banks because the capital ratios of the smaller banks remain quite good. I think the lending procedures of the banks, as a result of the difficulties that they have gone through and are still in the process of undergoing, are probably a bit tighter than they were. But they are still making loans to creditworthy borrowers.

As money becomes available, it will have to be put to work—partially by the banks; but, hopefully, other areas of the American financial structure will begin to make some of those loans. The commercial paper market, hopefully, will again become active and make some of the loans and take some of the burden off of the banks. Maybe that will release for the banking industry funds that can be used in ways such as you have cited, such as making loans to the expanding businesses, to the smaller businesses, and to others. These are loans that carry some risk, but not a disproportionate amount of risk.

Mr. MAGUIRE. Does the Federal Reserve have any policy here of working with banks to make these kinds of distinctions? Obviously the allocation of credit has been one approach that has been suggested.

But I find myself being very uncomfortable either with increasing overall risks or with decreasing overall risks. I would like banks and the Reserve to use some judgment at any given level of risk as to what kinds of loans ought to be granted. I am afraid that if we clamp down now and the banks clamp down and are afraid and what have you that minorities and small businesses and community projects will be the first to be set aside. I would like to see that kind of lending go on and have that kind of lending absorb the risk portion of the portfolio and get rid of some other nonsense which is simply unuseful risktaking, and which probably defeats what you and I would like to see.

How does the bank deal with that issue? Are distinctions made? Do you encourage banks to make distinctions?

Mr. LEAVITT. We have not normally in the supervisory function. This is a function more of looking at what they have done and criticizing the past actions and trying to keep the banks in a generally sound condition. It has probably been considered inappropriate for the supervisory function to urge banks to put their funds into any particular area.

Mr. MAGUIRE. So you are just dealing with aggregates and ratios of risk and so on.

Mr. LEAVITT. We do that; yes.

Mr. MAGUIRE. How do we avoid this kind of thing in the future? How do we avoid investments of the REIT variety which everybody now feels in retrospect were excessive and ill advised, and certainly not useful from the point of view of strengthening the economy or the social objectives which we might share? How do we avoid that in the future? What kind of role can the regulators play?

Mr. LEAVITT. I am not certain that we can avoid it. Clearly, though, we should all learn by everything that passes. From this most recent experience, the banks and the bank regulators have presumably learned a lot. You must remember that the people who are in responsible positions in both banks and bank regulatory authorities have for the first time had a severe economic recession with which to deal. I think we can learn a lot from our recent experience. And we do think about how we can recognize emerging problems either individually or in the aggregate sooner.

So I think that we can learn from this. And I think that in the future we probably can recognize such problems sooner.

I also want to say one thing with respect to disclosure of problem banks or banks that are subject to closer than normal surveillance. Requiring banks to disclose their classified assets would probably drive banks into an increasingly conservative role. If a bank knows that any time it gets classified assets over a certain percentage—you may take any percentage—that the market is going to be looking at it more closely, even though it may be only a couple of points below, it will say "No" to loans. And it may not be a bad loan.

Mr. MAGUIRE. That is exactly the problem that I am getting at here. And I think we ought to think together, if we can, about how to move beyond our present impasse of simply ratcheting the thing up or down on the basis of aggregates and levels of risk.

Wouldn't you personally prefer, at a set level of risk, that money be loaned to an innercity preservation and community development project or a minority business, as opposed to a real estate investment trust on the coast of Florida? There the purpose is simply to make a lot of money for people.

Mr. LEAVITT. One area where we have taken a firm stand over a long number of years is with respect to speculative loans. We have asked, and the Federal Advisory Council suggested, that the banks avoid the making of speculative loans.

Mr. MAGUIRE. But again you have the same problem. You can define anything as speculative.

Mr. LEAVITT. But some things clearly fall into that category without any redeeming social features.

Mr. MAGUIRE. There is another cross current here. If you were to want to discipline a bank which had really gotten to the point of being over the accepted boundaries with regard to the ratio of capital to assets or any of the number of measures that you use, you would presumably try to discipline that bank by perhaps reducing funds to the bank through the discount window or by some other steps, would you not?

Mr. LEAVITT. If we thought a bank had pushed things too far, we would talk to them. We have talked to them. Mr. John Ryan, who is the Assistant Director of the Division of Banking Supervision and Regulation, and who is seated next to me, has had a part in this. We have talked to organizations when we think that they have need for additional capital or when we might be concerned with the way in which they are going. We talk with them about a variety of such subjects. We talk about whatever might be the source of our concern about any given institution with the hope and expectation that they would then move to correct these things.

Mr. MAGUIRE. But you could then issue cease and desist orders.

Mr. LEAVITT. We could.

Mr. MAGUIRE. Have you? Or have you refused to approve acquisitions, if you choose to do so?

Mr. LEAVITT. Yes; if they are engaging in unsound and unsafe practices, we can. But many of these things about which we are talking occur before they ever get to a point of unsafe and unsound practice.

Mr. MAGUIRE. Would you include a reduction at the discount window as one of the things you might do?

Mr. LEAVITT. The discount window is not used probably as heavily as I think your question implies, Mr. Maguire.

Mr. MAGUIRE. I am really not implying anything. I am seeking information as to whether or not you might use that or have used it as a disciplinary tool.

Mr. LEAVITT. We would not use it, of course, if it were going to make it impossible for the bank to fund itself somewhere else. We could use the discount window as a leverage. We would not be able to use it practically.

Mr. MAGUIRE. In other words, you would threaten to use it, but you wouldn't use it.

Mr. LEAVITT. I'm sorry, sir. Let me start over again. Assuming that a given bank is borrowing and that we are concerned about the bank, then we work closely with a given bank to get out of the discount window as promptly as it can. But you often cannot cut off that loan immediately.

Mr. MAGUIRE. That's right. That is really the underlying reason for my question. At that point, discipline seems to cut across the natural desire and the proper desire that you might have to keep the bank in business. I don't know how you resolve that kind of dilemma.

Mr. LEAVITT. There are "Catch 22's" sometimes. They are very difficult to resolve because you have the desire on the one hand weighing against the desire on the other hand. And you have to weigh these conflicting goals or desires and try to come up with the solution that seems to be in the best interest of everyone. And normally that will almost always include keeping the bank in operation as a going and viable concern so that it can continue to serve the community in which it operates.

Mr. MAGUIRE. I think you have a very difficult and intricate assignment, Mr. Leavitt. I think the committee also has a lot of work to do to think this problem through and try to come up with proposals on how we can get to what probably are our shared goals.

Mr. Chairman, thank you very much.

Mr. ROSENTHAL. Mr. Leavitt, with regard to categories 3 and 4, discussed on page 6 of your testimony, are any of the five largest State member banks in those categories?

Mr. LEAVITT. Mr. Chairman, you asked that question in the letter which you sent over. I would like to answer that again by pointing to appendix 2 which indicates the great jump in the amount of deposits that are in category 3—from $4 billion in 1973 to $51 billion in 1974. The data are not as yet complete for 1975. I hope that that would satisfy your purpose.

Mr. ROSENTHAL. Obviously you understand what I am trying to do. I am asking you specifically, pursuant to question 7 in the letter inviting you to testify, whether any of the five largest State member banks are in categories 3 and 4.

Mr. LEAVITT. I have not been given authorization to answer the question as specifically put.

Mr. ROSENTHAL. Are you prepared to answer that question in executive session?

Mr. LEAVITT. No; I cannot, Mr. Chairman.

Mr. ROSENTHAL. Have you received instructions to decline to answer that question?

Mr. LEAVITT. Yes, sir.

Mr. ROSENTHAL. From whom did you receive those instructions?

Mr. LEAVITT. From the Board.

Mr. ROSENTHAL. Did the Board officially meet and pass a resolution to this end?

Mr. LEAVITT. No. There was not a resolution, but I was instructed not to answer the question.

Mr. ROSENTHAL. Do you have minutes of that meeting?

Mr. LEAVITT. Mr. Hawke, the Board's General Counsel, will answer.

Mr. ROSENTHAL. Were minutes kept of the meeting in which Mr. Leavitt's instructions were specified?

Mr. HAWKE. Mr. Chairman, minutes are kept of all Board meetings. This instruction to Mr. Leavitt was given during the course of the Board meeting. I cannot say whether the specific instructions to Mr. Leavitt are embodied in those minutes or not.

Mr. ROSENTHAL. Minutes were kept of the meeting in which those instructions were given? Yes or no.

Mr. HAWKE. Yes, Mr. Chairman.

Mr. ROSENTHAL. Do you have a copy of those minutes?

Mr. HAWKE. No; I don't.

Mr. ROSENTHAL. Will you furnish this committee with a copy of those minutes?

Mr. HAWKE. I will be happy to transmit that request to the Board, Mr. Chairman.

[The information referred to follows:]

EXCERPT FROM THE MINUTES OF THE MEETING OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ON FEBRUARY 2, 1976

Present: Mr. Burns, chairman; Mr. Mitchell, vice chairman; Mr. Holland; Mr. Wallich; and Mr. Partee.

Congressional testimony (Mr. Leavitt)

Mr. Leavitt was scheduled to testify before a subcommittee of the House Committee on Government Operations on February 3, 1976, regarding the supervision, regulation, and examination functions of the Federal Reserve System. A draft of the statement to be presented by Mr. Leavitt was before the Board today.

Discussion at today's meeting brought out a number of suggestions for changes in the wording, tone, and emphasis of the statement. It was *understood* that the statement would be revised in light of the comments expressed today, and that it would be presented in a final form satisfactory to Mr. Leavitt. (A copy of the statement in the form in which it was presented has been placed in the Board's files.)

Mr. Leavitt then referred to the Board's discussion last Friday of the confidentiality of examination reports, and he informed the Board that he anticipated that individual bank information would be requested at the forthcoming hearing.

While agreeing that information would be provided to Congressional committees on the general health of the banking system and the effectiveness of Federal bank supervision, the Board had previously decided not to breach the confidentiality of bank examination reports through the release of individual bank data. The Board *confirmed* this view today and *agreed* that, if asked for information about individual banks, Mr. Leavitt should decline to provide that information to the subcommittee.

The meeting then adjourned.

——— ———,
Secretary.

Mr. Rosenthal. In the American Banker article of January 23, 1976, it discusses the fact that the Fed approved new activities for at least 17 of the 35 bank holding companies on the special list. Is that an accurate statement?

Mr. Leavitt. The Fed clearly approved some. Without saying that the figures are exactly right, I would say that they approved some.

Mr. Rosenthal. If it is more or less correct, it is hard for a layman to understand how, when these 17 banks were on the problem list, you could give them more authority to continue going down the wayward road they were already on.

Mr. Leavitt. As I recall the article in the American Banker, Mr. Chairman, that article went back into 1974 and addressed itself to some actions that were approved by the Board during the year of 1974.

Mr. Rosenthal. Forgetting the article, did you enlarge the scope of activity of 17 banks that were on the problem list in 1973 or 1974?

Mr. Leavitt. Without addressing myself specifically to whether or not it was 17, I would say that the Board did permit some increase in the scope of activities of these companies. Such increase would normally have related to activities where there was essentially very little leverage; that is, the activities did not require much in the way of funding. It did permit the establishment of some de novo offices because it has been normally construed that such establishments of de novo offices are procompetitive and provide services in communities not heretofore served.

Mr. Rosenthal. Obviously I am not going to get a precise answer to that question. Let me try something else.

It has been reported that you blew the whistle on Franklin National Bank—you, Mr. Leavitt. Is that correct?

Mr. Leavitt. I had not thought so.

Mr. Rosenthal. Are you aware of the fact that it has been reported in Forbes, for example, that you blew the whistle on Franklin?

Mr. Leavitt. No; I don't remember that.

Mr. Rosenthal. Let me ask the question another way. Did you blow the whistle on Franklin?

Mr. Leavitt. Not to the best of my knowledge. If there were a whistle blown on Franklin National, I think that Franklin National must be given credit for blowing the whistle itself.

Mr. Rosenthal. When you say that, do you mean Mr. Roth's letter to the Board?

Mr. Leavitt. No; I mean that the Franklin National had problems which resulted in the market's losing its confidence and no longer providing funds. The capital ratios were low. As I indicated before, I don't think I should go very much further because we are involved in litigation at this time.

Mr. ROSENTHAL. Let me read this to you. In the July 1, 1974, issue of Forbes, in an article entitled "The Fed's Latest Weapon: Leavittation," it said: "It was Leavitt who blew the whistle on Franklin National's acquisition of Talcott Finance Company." And it continued:

> For a long time the Fed apparently felt that Franklin was taking too many risks in relation to its capital, but the Fed was powerless to act. Once Franklin's holding company applied to the Fed to make an acquisition, the Fed could turn it down, feeling that Franklin was already too far out on a limb.

Is that more or less an evaluation of the scenario? You couldn't do anything about it until they came in for an acquisition, and then you had them.

Mr. LEAVITT. As I stated earlier this morning, Mr. Chairman, at the time when we had clear regulatory authority involving the Franklin New York Corp., that corporation did in fact file that application.

Mr. ROSENTHAL. I know that. Were you unhappy with them prior to the opportunity you had to give them a little squeeze?

Mr. LEAVITT. When they filed the application, we looked at it carefully. Then there were certain things that, with this leverage, they did agree to do.

Mr. ROSENTHAL. Once you had the leverage, you were going to use it. But prior to the application, had you become concerned about the capitalization of Franklin?

Mr. LEAVITT. Prior to the application, we were relying upon the primary regulator.

Mr. ROSENTHAL. That is what I am getting at. What did you think of his performance up to that point when they filed the application?

I want you to know that you are testifying before a congressional committee—whether you are sworn or not—and there are serious repercussions if one does not respond in the way that we would expect you to respond.

Mr. LEAVITT. Normally, Mr. Chairman, I don't run around trying to evaluate the work of other regulatory agencies.

Mr. ROSENTHAL. Normally you are not asked by a congressional committee. Now you are being asked. What did you think of the performance of the Comptroller of the Currency, vis-a-vis Franklin, as of the time you got the Talcott application?

Mr. LEAVITT. I can only assume that the Comptroller of the Currency was taking all of the steps that he thought that he could in order to correct whatever situation might have been disturbing at the time that I looked at the case.

You must remember, Mr. Chairman, that the information at which I was looking was contained essentially in examination reports that were prepared by the Comptroller of the Currency.

Mr. ROSENTHAL. At the time you got the Talcott application, had you the advantage of an inhand review of the Comptroller's examination reports?

Mr. LEAVITT. I can't say whether I had it in hand at that time; but, certainly prior to the time the board would act, we would have looked at it.

Mr. ROSENTHAL. Did you, yourself, read the examination reports?

Mr. LEAVITT. Do you mean that specific one, or generally, sir?

Mr. ROSENTHAL. Did you read the examination reports of Franklin?

Mr. LEAVITT. Yes; I have read the examination reports of Franklin.

Mr. ROSENTHAL Had you read them prior to the Talcott application?

Mr. LEAVITT. I honestly don't know.

Mr. ROSENTHAL. Did you find your reading of the examination reports useful in making a determination as to the efficacy of Franklin?

Mr. LEAVITT. We find the review of examination reports always useful in our consideration of any application.

Mr. ROSENTHAL. Why?

Mr. LEAVITT. That indicates to us the condition of at least one of the subsidiaries of a bank holding company. And when bank holding companies apply to expand, we, of course, are interested in the condition of the company and its various subsidiaries.

Mr. ROSENTHAL. Why are you not satisfied with their financial statement? Why do you have to read the examination reports?

Mr. LEAVITT. There is, of course, a great wealth of information that is publicly available and on which we place heavy reliance. There is a certain other type of information that is generally the type that is used for supervisory purposes. It is a specialized type of information and needs, to some degree—although I don't mean to make it sound too esoteric—a certain amount of experience to read it and to make the proper assessments.

Mr. ROSENTHAL. Do you recall in the Comptroller's examination reports on Franklin whether there were any recommendations for disciplinary action or any other kind of recommendations?

Mr. LEAVITT. I can't answer that specifically, Mr. Chairman. I just can't.

Mr. ROSENTHAL. Do you review your own examiner's reports to see whether there have been followups with recommendations?

Mr. LEAVITT. Normally I would not personally review the examination report.

Mr. ROSENTHAL. Mr. Levitas.

Mr. LEVITAS. I have one question, Mr. Chairman, which is in line with one which you have asked and is relative to reliance on the financial statements. The answer was that a more specialized type of information is necessary in order to determine security or safety of the bank from a regulatory point of view.

Would you believe that the information to be required by the Securities and Exchange Commission of banks for public reporting would be sufficient in and of itself for a depositor or for a regulator to determine safety? Or would you still think additional information was necessary from the regulatory point of view?

Mr. LEAVITT. We are talking about two different things here. On the one hand, we are talking about information for the depositors and for the shareholders. The Securities and Exchange Commission is very interested, appropriately, in the shareholders.

The information that is being made available and the further information that will be made available as of the end of the first quarter of this year will provide for the shareholders and depositors a great amount of information—probably more information than is routinely provided for comparable use by other corporations. Then the supervisory process, it seems to me, goes one step beyond that, Mr. Levitas.

Banks are a little bit unusual. They hold the people's money. The banking system is so important that the Congress of the United States has seen fit to say, it seems to me: "Provide this information to the public on the one hand, and then you look just a little bit harder at them to make sure that they are doing it." And that information, it seems to me, embodies, then, a relationship between the banker and the bank regulator in order that we get that in a spirit of give-and-take or cooperation, rather than in a spirit of confrontation. And the best interests of the country are served by keeping these two separate and distinct.

Mr. LEVITAS. And the reason that additional information is needed by the regulator is because its responsibilities of determining security and safety of the bank are different from those required for public disclosure in regulation by the SEC.

Mr. LEAVITT. I think so.

Mr. LEVITAS. Thank you. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Mr. Leavitt, on page 44 of your statement, at the bottom, you say: "These actions obtained results. A number of banks' and bank holding companies' managements recognized their problems and realined their lending policies to obtain more sound credit decisions. . . ." You list a whole host of things. We need some confirmation of these things. How can you provide that to the subcommittee?

Mr. LEAVITT. With respect at least to the capital one, we can provide some information about capital increases that have come into the banks and the bank holding companies. Governor Coldwell, when testifying the other day on some of the discussion principles of the Fine Commission, reported on that.

Mr. ROSENTHAL. I don't mean to interrupt you, but let's just take the first one—they have realined their lending policies to obtain more sound credit decisions. How do we know if that is correct or not?

Mr. LEAVITT. One thing on the credit policies was annual reports of companies.

Mr. ROSENTHAL. Annual reports delivered to banks?

Mr. LEAVITT. Annual reports of bank holding companies or annual reports of certain banks indicated some of these things last year. Now the date for filing their 1975 reports is not yet upon us.

Mr. ROSENTHAL. Now as I count these, there are four steps. Would you prepare a statement for inclusion in the record showing how you base these judgments and whether you are satisfied with these things?

Mr. LEAVITT. Yes.

[The information referred to follows:]

The attached inserts support the actions outlined in Mr. Leavitt's statement before the above subcommittee.

The actions outlined in the statement were undertaken by the managements of the banks and bank holding companies to reverse the problem situations which arose in the 1970's. Insert 1 contains excerpts from 1974 annual reports of some of the largest bank holding companies. The comments contained therein generally indicate a shift away from a policy of rapid growth toward one of greater restraint with priority on quality of assets and stability of earnings.

Insert 2 contains liquidity data for large commercial banks. These data reflect significant improvements in bank liquidity as indicated by the decrease in the loans to deposit ratio and the increase in the ratio of U.S. Treasury securities to total deposits. Improved liquidity is further indicated under the "Liabilities" section which reflects managements' efforts to reduce reliance on borrowed funds.

Insert 3 contains the payout ratio over the last 5 years for some of the largest bank holding companies. These ratios indicate a trend toward a greater retention of earnings to strengthen the capital base. Further strengthening of the capital base is indicated by Insert 4 which contains an excerpt from the testimony of Governor Philip E. Coldwell presented on January 28, 1976, before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Currency and Housing.

These inserts support our contention that the managements of a number of banks and bank holding companies have recognized their problems and are taking the corrective steps necessary to improve the problem situations.

EXCERPTS FROM THE 1974 ANNUAL REPORTS OF VARIOUS BANK HOLDING COMPANIES

Bank America Corp.

After careful consideration, management has recommended—and your directors have unanimously approved—that our banking operations shift toward a policy of greater restraint. That policy, in effect since mid-summer 1974, continues to reflect management's belief that, in times of high interest rates and unprecedented loan demand, the public is better served by a policy that gives a higher priority to the quality of assets and the stability of earnings than to size alone. In the process of implementing credit restraint, the corporation made special effort to continue to accommodate essential credit needs of the consumer, home buyer and small business owner. The most stringent credit restraint was aimed at the type of financing classified either as "speculative" or "loans for nonproductive purposes." This policy also stressed improving the quality of business credits. Limitations on the growth of stable sources of funds, such as consumer demand and savings deposits, and the lack of other sources in the marketplace, made it necessary to limit the granting of new real estate loans, in order to maintain a proper balance between stable sources and uses of funds.

Bankers Trust

In 1975, our primary objective in the U.S. market is to improve the quality and profitability of our loan account. We believe loan demand will be substantial throughout the year and we intend to be selective in making new loan commitments.

Chase Manhattan Corp.

As we look to the future, it is clear we must give more emphasis to some of our basic strategies. While we have long stressed both increased assets and increased earnings on assets, volume has been a critical ingredient of the earning growth of Chase and other financial institutions. Now our performance must more and more be measured by the return we generate on assets, the discipline with which we manage them, and the rigor of our controls. This means that we must continue to upgrade the quality of our loans and to price our services fairly and profitably.

Continental Illinois

Looking ahead to 1975, we recognize the need for caution in confronting major problems that face many areas of the economy. The bank, which remains the bulwark of our organization, will be managed under a policy of restrained growth with particular emphasis on controlling costs, the quality of our loans, and our pricing. Evidence that these controls are effective is found in the fact that—while we continue responding to the legitimate credit needs of our customers at home and abroad—loans outstanding in early 1975 stand at about the same level as in mid-1974, yet our capital and loan-loss reserves are both much stronger. These conditions provide sound assurance for the future.

Crocker National Corp.

Our task in 1974 was to mobilize our substantial resources and strengthen our organization so that Crocker can become the competitive and profitable institution that it deserves to be. Crocker assets have traditionally been of high quality. Our task is to improve the asset mix so as to enhance the return without unnecessarily increasing the risk. During the year, we were successful in reducing the size of our real estate mortgage portfolio. . . . Commercial and industrial loans, personal loans, and agricultural loans have all substantially increased. We are also seeking ways to reduce our investment in fixed assets, and to convert them to earning assets.

First Chicago Corp.

It is in the field of domestic wholesale banking that we have the greatest expertise, and it is here that we make the major portion of our earnings. In 1974, this important segment of our activity involved:

(*a*) A rapid increase in loans for the first 7 months followed by a fairly level volume later in the year;

(*b*) A doubling of our provision for loan losses;

(*c*) A revision of our pricing; and

(*d*) Continuous attention to effective funding.

These influences caused us to make two significant changes in our loan policy: First, we reversed the declining trend in our rates. Second, we became more restrictive in our lending. We declined new credit business and more closely monitored increases in lines to our existing customers. Our intention to moderate loan growth suggests that our objective of a continued annual rise in earnings will require that we increase the rate of return on our assets. Thus, early in 1974, when we shifted our emphasis away from volume, we adjusted our pricing for both the credit and the services which we offer. In mid-1974 we adopted the more conservative policy of leveling out and extending the maturities of our outstanding certificates of deposit ("C/D's"). Looking ahead, we believe that the trend toward lengthened maturities in the purchased money portfolio will continue, perhaps accelerating in the months immediately ahead as short-term rates move lower. Federal Reserve practices encourage the lengthening of maturities by requiring a reserve of 6 percent against certificates of deposit maturing in 180 days or less, whereas C/D's of over 6 months maturity require only a 3-percent reserve.

First National Boston Corp.

It is quite clear that the Federal Reserve Board wishes to slow the growing leverage of bank holding companies and as prudent managers we must assume that future asset growth will come only from our proportionate leverage on additions to capital, either through the issuing of securities or from retained earnings. If this assumption is correct, then bankers must recognize the precious value of their capital and insist upon more discriminating employment of their assets. Exceptional loan risks in the heat of competition are no longer acceptable nor should scarce resources be committed at fractional spreads and low commitment fees. In terms of a sounder banking system, this represents a healthy development.

First Pennsylvania Corp.

That 48 percent of the bank's loans that we charged off in 1974 were prime rate borrowers attests to the attention that bankers must now pay to the changing currents of economic activity. A very heavy proportion of the loans that we make are collateralized or secured in some way. Another result of the trauma of 1974 has been for banks to become even more conservative in their accounting practices. Many large banks—including First Pennsylvania—have chosen to replenish their loan-loss valuation reserves by amounts in excess of that which was called for by the 5 year averaging formula. Despite the penalty to earnings, it was felt that common sense dictated a more realistic charge to earnings and that a "traditional" formula which failed to reflect contemporary conditions should be discontinued.

J. P. Morgan, Inc.

The immediate prospects for further growth are dimmed by the deepening recession in the United States, the condition of economic decline prevailing in many of the other major countries, and the general uneasiness which a series of upheavals has imparted to all financial markets. We intend to pursue a cautious course in these circumstances. This does not mean withdrawal from any of the activities with which we are identified. We shall continue to be ready lenders for soundly conceived purposes and to be active participants in the markets where we have established our place. But our emphasis, more than ever, will be on soundness and quality, not size. Banking is a more vital business today than it was a generation ago. A moderate easing of regulatory strictures has permitted this change. Utilizing the leeway afforded, banks provide more services than before, sponsor more innovations, offer the public alternatives not previously available, and in the process step on some competitive toes. In all this, mistakes have been made, but on the whole banking has filled its broadened role responsibly and society has been the gainer along with the banks and their stockholders.

Wells Fargo & Co.

The Company's strategy to constrain the growth of earning assets while improving the net yield on those assets has proved successful, even though the unfavorable financial climate and heavy loan demand made 1974 a difficult time to institute new policies. Implementation of the strategy has resulted in the funding of higher yielding assets, a reduction of activities in lower yielding areas of banking operations, and less reliance on high cost borrowings to fund incremental asset growth. The Company expects to continue these policies throughout 1975 and the years ahead.

Western Bancorporation

United California Bank is WBC's major money center bank, UCB concentrated on improving earnings during 1974. Action programs included changing the mix of the bank's assets, lengthening liability maturities and containing staff size. Pricing techniques on loans were sharpened and liquidity was improved as loans were held at the $5-billion level during the year. Thrusts for 1975 include further margin and earnings gains, continuing the control of loan volume, and developing the plans and programs for garnering and improving share of retail business.

SELECTED LIQUIDITY DATA OF LARGE COMMERCIAL BANKS

[In millions of dollars]

	1970		1971		1972		1973		1974		1975	
	June 24	Dec. 30	June 30	Dec. 29	June 28	Dec. 27	June 27	Dec. 26	June 26	Dec. 31	June 25	Dec. 31
Total assets	304, 350	337, 118	351, 094	367, 364	374, 564	410, 588	424, 785	457, 302	489, 024	529, 351	502, 052	527, 387
Total deposits	230, 185	266, 798	284, 888	293, 631	295, 859	327, 540	329, 911	350, 097	369, 035	413, 412	384, 227	411, 903
Loans: Loans [1] total deposits	0. 7369	0. 6695	0. 6415	0. 6543	0. 6876	0. 6942	0. 7661	0. 7730	0. 7899	0. 7339	0. 7334	0. 6892
Investments:												
U.S. Treasury securities/total deposits	0. 0941	0. 1052	0. 0934	0. 0986	0. 0879	0. 0874	0. 0723	0. 0729	0. 0568	0. 0579	0. 0822	0. 0975
U.S. Treasury bills, notes, and bonds maturing within 1 yr:												
Absolute	5, 256	10, 278	7, 880	8, 105	8, 411	11, 221	7, 995	9, 888	5, 289	8, 126	11, 960	20, 425
Percent of total investments	0. 0881	0. 1424	0. 1032	0. 1000	0. 1051	0. 1325	0. 1007	0. 1154	0. 0629	0. 0935	0. 1297	0. 2035
U.S. Treasury notes and bonds maturing within 1 to 5 yrs:												
Absolute	14, 130	15, 061	15, 347	16, 622	14, 928	14, 874	13, 014	12, 228	11, 753	12, 204	16, 359	16, 959
Percent of total investments	0. 2367	0. 2086	0. 2010	0. 2050	0. 1864	0. 1756	0. 1639	0. 1427	0. 1397	0. 1405	0. 1775	0. 1690
Liabilities:												
Federal funds purchased and securities sold under agreements to repurchase:												
Absolute	17, 758	18, 775	19, 053	26, 046	28, 934	31, 085	37, 077	47, 759	51, 325	44, 269	50, 141	44, 074
Percent of total assets	0. 0583	0. 0557	0. 0543	0. 0709	0. 0722	0. 0757	0. 0873	0. 1044	0. 1049	0. 0836	0. 0999	0. 0836
Negotiable certificates of deposit issued in denominations of $100,000 or more:												
Absolute	12, 976	26, 075	28, 527	34, 018	35, 985	44, 911	59, 519	64, 391	80, 176	92, 978	81, 996	83, 088
Percent of total assets	0. 0426	0. 0774	0. 0813	0. 0926	0. 0959	0. 1094	0. 1401	0. 1408	0. 1639	0. 1757	0. 1633	0. 1575

[1] Excludes Federal funds sold and securities purchased under agreements to resell.

Source: Federal Reserve bulletin.

PAYOUT RATIO FOR 20 OF THE LARGEST BANK HOLDING COMPANIES

Holding company and location	Payout ratio				
	1970	1971	1972	1973	1974
BankAmerica Corp., San Francisco, Calif	46	42	42	39	38
Bankers Trust New York Corp., New York, N.Y	54	53	49	48	44
Charter New York Corp., New York, N.Y	54	62	61	54	44
The Chase Manhattan Corp., New York, N.Y	43	43	43	39	39
Chemical New York Corp., New York, N.Y	47	54	62	57	45
Citicorp, New York, N.Y	48	43	37	33	31
Continental Illinois Corp., Chicago, Ill	42	43	40	38	39
Crocker National Corp., San Francisco, Calif	50	49	51	53	68
First Chicago Corp., Chicago, Ill	37	37	39	35	33
First National Boston Corp., Boston, Mass	43	45	44	38	38
First Pennsylvania Corp., Philadelphia, Pa	41	41	38	38	49
Manufacturers Hanover Corp., New York, N.Y	46	56	56	45	39
Marine Midland Banks, Buffalo, N.Y	48	52	50	55	59
Mellon National Corp., Pittsburgh, Pa	44	50	53	46	42
J. P. Morgan & Co., Inc., New York, N.Y	45	46	43	38	34
National Detroit Corp., Detroit, Mich	31	37	39	34	33
Seafirst Corp., Seattle, Wash	38	34	35	34	30
Security Pacific Corp., Los Angeles, Calif	38	44	46	45	51
Wells Fargo & Co., San Francisco, Calif	45	43	40	40	38
Western Bancorporation, Los Angeles, Calif	41	45	43	42	99

EXCERPT FROM CONGRESSIONAL TESTIMONY

In his testimony before the Subcommittee on Financial Institutions, Regulation and Insurance on January 28, 1976, Governor Coldwell described improvements which had been made in the capital positions of holding company subsidiaries. The relevant portion of that testimony is as follows:

". . ., bank holding companies have improved the financial condition and management of many of their newly-acquired banks. Of particular importance has been the provision of additional capital. In 397 separate approvals of holding company acquisitions, the Federal Reserve has conditioned its approval on, or reached agreement with the applicant for, an injection of new capital. Such applicants have provided almost $788 million of new capital as a result of these acquisition agreements and bank holding companies, often after urging by the Federal Reserve, have put in an additional $1,154 million in new capital. In total then, bank holding companies have injected almost $2 billion of new capital funds into subsidiaries. While a part of this total might have been injected without the holding company form or the requirements of the Federal Reserve, it is doubtful that the total would have been nearly so large."

Mr. Rosenthal. On page 6, you talk about category 3. Is Marine Midland in either category 3 or 4?

Mr. Leavitt. Mr. Chairman, I have not been given permission to discuss individual banks.

Mr. Rosenthal. Has that information appeared in the newspapers, as best you know?

Mr. Leavitt. There was a statement with respect to the holding company of Marine Midland that did appear in the New York Times.

Mr. Rosenthal. And it was repeated in the January 23 issue of the American Banker.

Mr. Leavitt. Yes.

Mr. Rosenthal. That article says: "The $11.2 billion-asset Marine Midland Bank, Buffalo (Marine Midland Bank, New York)." Is that correct or incorrect?

Mr. Leavitt. The memorandum was my memorandum, Mr. Chairman. There is no question about that.

Mr. Rosenthal. So it was in category 3 or 4?

Mr. Leavitt. Yes—to the extent of whatever was contained in the memorandum. The memorandum was my memorandum.

Mr. ROSENTHAL. On page 8 of your testimony when you talk about correcting some of the problems that you find, you say: "The steps range from early attempts at 'moral suasion' to meetings of the bank supervisors with boards of directors . . ." We want to know whether you are doing your job properly or not. Now you should not take offense at that. This is our job.

Mr. LEAVITT. I don't; I don't.

Mr. ROSENTHAL. Now we need to know in what cases you used "moral suasion" and what happened. In what cases did you put on boxing gloves, and what happened? In what cases did you issue cease and desist orders, and what happened? And what happened prior to the 17 cease and desist orders since 1972?

How can we make a judgment of whether or not you are doing your job if we don't know what happened?

Mr. LEAVITT. I think it is fair to state that the Board also feels that some way should be determined in order that the Congress of the United States can be provided certain information and to permit the Congress of the United States to make judgments of the type to which you refer, Mr. Rosenthal.

Mr. ROSENTHAL. Do you have any ideas? We have some ideas which are developing rapidly, but I would like to hear your ideas.

Mr. LEAVITT. I would really like an opportunity to think them through further before giving them. They are not really jelled and I would like an opportunity to think them out much more.

[The information referred to follows:]

The attached inserts provide some information on the steps which are implemented throughout the Federal Reserve System to correct troublesome situations. The steps were referred to in Mr. Leavitt's statement before the above subcommittee.

Insert 1 indicates the number of instances (categorized by the quality rating of the bank in question, and by the district or region in which the bank is located) in which an official of the examination department of the Reserve Bank has met with a bank's board or board committee. The number of meetings held by examiners-in-charge with boards of directors at the conclusion of the examination for the same periods is *not* included.

Insert 2 provides information for the past five years on the Cease and Desist Orders which have been issued by the Board of Governors under the Financial Institutions Supervisory Act of 1966.

Chairman Rosenthal further requested information on the instances in which moral suasion was used. Definite figures are not available to indicate the number of times this step was used since moral suasion is constantly relied on by the supervisory authorities as a tool to implement correction of such problems as violations of laws or regulations, insufficient capital and/or liquidity, excessive loan classifications, deficient credit files and collateral documentation, unsound lending and investment policies, and inadequate records and internal controls.

MEETINGS WITH A BANK'S BOARD OF DIRECTORS

	Number of banks	Rating of banks		Number of banks	Rating of banks
Federal Reserve Bank of Boston:			Federal Reserve Bank of Philadelphia:		
1972	None		1972	1	3
1973	None			2	2
1974	1	3	1973	2	2
Federal Reserve Bank of New York:			1974	2	2
1973	None	(1)		1	3
1974	2				
1975 [2]	2				

Footnotes at end of table.

MEETINGS WITH A BANK'S BOARD OF DIRECTORS—Continued

	Number of banks	Rating of banks
Federal Reserve Bank of Cleveland:		
1973	1	2
	1	3
1974	None	
1975 [1]	2	3
Federal Reserve Bank of Richmond:		
1973	2	2
	1	3
1974	1	2
	3	3
	6	2
1975 [1]	4	3
Federal Reserve Bank of Atlanta:		
1973	3	3
1974	1	4
1975 [1]	1	4
	2	3
Federal Reserve Bank of Chicago:		
1973	1	1
	2	2
	3	3
1974	2	2
	4	4
1975 [2]	3	1
	9	2
	5	3
	4	4
Federal Reserve Bank of St. Louis:		
1972	None	
1973	1	2
1974	None	
Federal Reserve Bank of Minneapolis:		
1972	2	1
	2	2
	2	3
1973	2	2
	2	3
1974	3	2
	3	3
Federal Reserve Bank of Kansas City:		
1972	2	3
1973	2	3
1974	2	3
Federal Reserve Bank of Dallas:		
1973	2	3
1974	3	3
1975 [2]	1	3
Federal Reserve Bank of San Francisco:		
1972	1	3
1973	1	3
1974	2	3

[1] 3 banks rated hazardous and 1 rated unsatisfactory.
[2] Data for 1975 incomplete.

Following are the number of instances in which there was more than one meeting with a Board or Board Committee, and the frequency of such meetings:

Federal Reserve bank	Number of banks	Number of meetings	Frequency
Boston:			
1972	None		
1973	None		
1974	1	4	Apparently determined by the severity of the problem.
New York: 1973 through 1975	None		
Philadelphia: 1972 through 1974	None		
Cleveland:			
1972	None		
1973	None		
1974 through 1975	1	2	Aug. 27, 1974, and Apr. 24, 1975.
Richmond:			
1973	1	2	See comments below which were furnished by the Federal Reserve Bank of Richmond.
1974	None		
1975	2	2	
Atlanta: 1972 through 1974	None		
Chicago: [1]			
1973	None		See comments below.
1974	1	2	
1975	2	2	
	1	3	
St. Louis: 1972 through 1974	None		
Minneapolis:			
1972	1	4	August through November 1972.
	1	2	July and December 1972.
	1	2	February and December 1972.
1973	None		
1974	1	4	March, July, September, and December 1974.
	1	2	June and October 1974.
Kansas City:			
1972	1	2	Officers of the Federal Reserve bank meet with the directors of the bank at the conclusion of the examination and again after the report is prepared at which time State supervisory authorities are invited to attend.
1973	2	2	
1974	1	2	
Dallas: 1973 through 1975	None		
San Francisco: 1972 through 1974.	None		

Bank does not have a regular schedule. Meetings are planned as the supervisory authorities feel they are needed.

It is also important to note that in some instances the fact that only one meeting was held within a calendar year does not mean that a second meeting was not held within less than 12 months. Banks with significant problems are scheduled for frequent examinations; thus, a meeting may follow examinations made in the last half of one year and the first half of the following year.

CEASE AND DESIST ORDERS ISSUED DURING THE PAST 5 YEARS

1976.—4 Orders (2 bank holding companies, 2 banks).

Three Orders dealt with prohibitions against insider loans and provisions for repayment of those loans and prohibitions against violations of Regulation Y with corrective provisions.

One Order dealt with bootstrapped bank holding companies and required capital injections on the part of principals responsible for the bootstrap, the repurchase of given amounts of treasury shares, dividend limitations, and prohibitions against lending to affiliated corporations or individuals.

1975.—9 Orders (5 bank holding companies, 1 bank, 3 removals).

Three Orders dealt with a failure to file financial information as required by the Bank Holding Company Act and Regulation Y. Corporations were to cease and desist from further violations and file required information within 30 days.

Two Orders involved illegal accounting practices, deficiencies in loan collection policies, excessive dividends, the sale of notes without proper repayment capacity on the part of the issuer, and insider borrowing. The resultant order prohibited dividends and the further sale of promissory notes, provided for the systematic retirement of insider debt and the reduction of corporate debt, the establishment of collection procedures on loans, and the immediate correction of accounting procedures.

One Order concerned a failure to maintain back-up lines on commercial paper, the payment of excessive dividends, the redemption of shares that was resulting in serious capital depletion, and unsound lending practices to affiliates. The resultant order precluded loans to affiliates, required the maintenance of back-up lines of credit, limited dividends and share redemption, and placed a ceiling on salaries and fees.

Three Orders removed individuals from the management of banks and/or bank holding companies after said individual's indictment for felonies involving breach of trust.

1974.—None.

1973.—None.

1972.—4 Orders (3 banks, 1 removal).

Two Orders concerned unsound securities concentrations, excessive dividends and share redemption, and unsound interest on the redemption of capital notes. The resultant Order limited dividends and stock redemption, as well as the interest paid on and redemption of capital notes.

One Order dealt with the extension of credit to insiders without full disclosure and in amounts in excess of the borrowers' ability to repay, violations of 22(G) of the Federal Reserve Act, and Regulation O, and insider self-dealing. The Order required the repayment of insider borrowings, limitations on further credit extensions to insiders, precluded further self-dealing, and terminated the self-dealing contracts then in existence.

One Order sought the removal of a bank director for personal dishonesty. This was the only proceeding involving court action, and was eventually settled by agreement between the parties.

Mr. ROSENTHAL. The Comptroller of the Currency did submit a proposal some few days ago. Did you see his proposal?

Mr. LEAVITT. Yes, sir; I did.

Mr. ROSENTHAL. Did you help write it?

Mr. LEAVITT. No.

Mr. ROSENTHAL. We are responding to that proposal some time this week, I suppose.

But now what you have really told us, or the only conclusion that I can come to, is that the recession has regulated banks, and not the regulators. We have no proof that you have regulated them.

Mr. LEAVITT. It is difficult to offer proof, of course, in an area which has been so confidential as has been the bank examination function over a long period of time. I recognize that. It is difficult to prove these things. We are hoping that some way can be found which will point up the type of work that has been done.

Mr. ROSENTHAL. On page 11, you say: "At the present time, the Board's staff is monitoring the condition of 63 bank holding companies, some of which were included in the January 1975 report." When you say you are "monitoring," what are you doing?

Mr. LEAVITT. We do a variety of things, Mr. Chairman. That depends, to a significant degree, upon the level of concern. The level of concern varies considerably. In some cases, we may ask them to come in and discuss with us their plans and programs. And once they even discuss with us their plans and programs, it is going to take them quite a little bit of time to work out all of these programs. In many of the instances, they will go to troublesome assets. Now I do not find the troublesome asset question so difficult as some people might find it. The banks, I believe, and the holding companies generally know the extent of problems that confront any individual institution. They have, as the earnings data now being reported indicate, made significant transfers to bad debt reserves during the year just ended. These transfers were normally made after consultation with their accountants and they revealed the extent of the accountants views about loss probability in the portfolio.

Still, it is going to take a considerable amount of time to work out several of these problems; so we monitor them and we will call them in if we have reason to. Otherwise, they work through the Federal Reserve banks and let us know the programs. It can be a variety of things. It can be in the form of a letter, a telephone call, or a number of things.

Mr. ROSENTHAL. Also in evaluating your performance, I think that we should have an opportunity to peruse the five cases where the Reserve bank entered into agreements with holding companies. Are you prepared to tell us the names of the holding companies which were entered into the agreements?

Mr. LEAVITT. Oh, no; that would again constitute——

Mr. ROSENTHAL. That would violate your instructions?

Mr. LEAVITT. That is correct, sir.

Mr. ROSENTHAL. Are you prepared to do that in executive session?

Mr. LEAVITT. No; I am not.

Mr. HAWKE. I might also point out that there is a specific statutory inhibition on disclosure of information concerning these cease and desist proceedings.

Mr. ROSENTHAL. What section is that?

Mr. HAWKE. That is the Financial Institutions Supervisory Act of 1966.

Mr. ROSENTHAL. That does not include giving the information to relevant committees of Congress.

Mr. HAWKE. That statute prohibits the agency from making public information about a cease and desist proceeding unless it makes certain findings that disclosure would be in the public interest.

Mr. ROSENTHAL. The statute specifically excludes from the prohibition relevant committees of Congress. Are you aware of that?

Mr. HAWKE. I think, Mr. Chairman, that you may be referring to the Freedom of Information Act.

Mr. ROSENTHAL. No; I am not.

Mr. HAWKE. I am referring to the Supervisory Act.

Mr. ROSENTHAL. We will have other opportunities to discuss this and we will not burden Mr. Leavitt with these legal definitions.

Are the cease and desist orders filed in any court? Are they made public in any way at all?

Mr. LEAVITT. No; they are not made public.

Mr. ROSENTHAL. Is there any statutory authority for the issuing of a cease and desist order?

Mr. HAWKE. Section 1818 of title 12, U.S.C.

Mr. ROSENTHAL. And you issue an order for a U.S. citizen or for a corporation to do something and it is your contention that that must remain secret?

Mr. HAWKE. That is what the statute provides, Mr. Chairman, unless the board makes specific statutory findings that the proceeding should be made public. Now that was put in there in the interest of protecting the institutions involved. The legislative history is quite clear on that.

Mr. ROSENTHAL. We are going to conclude this hearing now. But prior to your preparing for us a proposal as to how you think we can do our job more effectively, Counsel, we will submit to you a draft of the memorandum of the American Law Division on which we base the authority to receive all of the information that you, as of this moment, have denied the subcommittee. And we shall try to explore in an amicable and friendly way an appropriate resolution.

Thank you very much. The subcommittee stands adjourned.

[Whereupon, at 12:25 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

Mr. HAWKE. I think Mr. Phillips [illegible] that [illegible] in [illegible] the [illegible] of Information Act.

Mr. [illegible]. [illegible] I am not.

Mr. HAWKE. [illegible] the [illegible] Yes.

Mr. [illegible]. We [illegible] opportunity to discuss this [illegible] with [illegible] Mr. [illegible] with the [illegible]

[illegible] or [illegible] Are they made public [illegible] at all?

Mr. [illegible]. [illegible] made public.

Mr. [illegible]. [illegible] for the [illegible] or [illegible] order?

[illegible]

Mr. [illegible]. And [illegible] for [illegible] as [illegible] that that [illegible]

Mr. HAWKE. [illegible] Mr. Chairman, unless the [illegible] the [illegible] should be made public [illegible] in the [illegible] I [illegible] quite clear on this.

Mr. [illegible]. We [illegible] conclude this hearing now. [illegible] to your [illegible] we can [illegible] we will submit to you a draft of [illegible] which we have [illegible] of the [illegible] of the [illegible] and [illegible] to [illegible]

Thank you very much. The subcommittee stands adjourned.

(Whereupon, at [illegible] the subcommittee adjourned, to [illegible] subject to the call of the Chair.)

OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF FEDERAL BANK REGULATION

(Regulation of Problem Banks)

WEDNESDAY, JUNE 16, 1976

HOUSE OF REPRESENTATIVES,
COMMERCE, CONSUMER,
AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:35 a.m., in room 2203, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal and Garry Brown.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Ronald A. Klempner, counsel; Doris Faye Taylor, clerk; and Henry Ruempler, minority professional staff, Committee on Government Operations.

Mr. ROSENTHAL. The subcommittee will come to order.

Since early last year, the Commerce, Consumer, and Monetary Affairs Subcommittee has been engaged in a comprehensive oversight review of the Federal bank regulatory agencies. These agencies—the Office of the Comptroller of the Currency, the Federal Reserve, the FDIC, and the Federal Home Loan Bank Board—regulate almost 20,000 financial institutions with assets aggregating over $1 trillion. They are probably the most important and, until recently, the least scrutinized regulatory agencies in Washington.

In connection with the problem bank phase of our review, the subcommittee sought the issuance of subpenas for examination of a number of large national banks.

Instead, the full Government Operations Committee adopted a resolution calling for a performance audit by the General Accounting Office of the operations of the bank agencies.

For many years, the GAO had been denied access, by these agencies, to key examination and supervisory documents. As a consequence, the GAO had not been able to provide Congress with meaningful reports on the effectiveness of the bank regulators.

In recognition of congressional and public concern over bank stability and effective supervision of banks, the banking agencies agreed to a GAO management and performance audit and unrestricted access to all key regulatory documents.

We have asked the Director of the GAO Task Force on Federal Supervision of Banks to come before the subcommittee to explain the specific areas of Federal bank regulation to be covered by the GAO study and to tell us what manpower resources have been committed by GAO to the study.

I believe that if the GAO study is as thorough as we all hope and is responsive to the subcommittee's suggested study proposal contained in our letter to Mr. Staats of April 16, 1976, it will have a great influence on the nature and direction of future congressional investigations and legislation in the banking area.

Our witnesses this morning are Mr. Fred D. Layton, Director of the Task Force on Federal Supervision of Banks, General Accounting Office.

He is accompanied by Mr. Donald Pullen, Assistant Director of the task force.

Mr. Layton?

STATEMENT OF FRED D. LAYTON, DIRECTOR, TASK FORCE ON FEDERAL SUPERVISION OF BANKS, GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY DONALD PULLEN, ASSISTANT DIRECTOR

Mr. LAYTON. We are pleased to be here at your invitation to explain our plans to study the supervision of banks by the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation.

In the past few years, some large banks have failed—and much publicity has been given to so-called problem banks lists. These events have evoked concern in the Congress about the banking industry and how well it is regulated by the Federal supervisory agencies.

Both this subcommittee and the House Committee on Banking, Currency and Housing have requested GAO studies of the effectiveness of the three supervisory agencies in carrying out their bank supervision responsibilities.

The Senate Committee on Banking, Housing and Urban Affairs has expressed interest in our study.

The committees have raised the following questions which we will explore in our study.

1. Are bank examinations of sufficient scope to identify management weaknesses and financial difficulties in banks and to determine the banks' compliance with laws and regulations?
2. Are examination procedures applied consistently?
3. Do bank examiners have sufficient experience and training?
4. Are findings and recommendations of examination reports acted on effectively?
5. Do the agencies have sufficient authority to deal with bank problems and are they making appropriate use of the powers they have?
6. What are the criteria used by the Office of Comptroller of the Currency in issuing charters and are the criteria applied consistently?

As you know, in the past we have not had access to bank examination reports and related documents of the three agencies. We have no statutory right of access to the records of the Comptroller of the Currency or the Federal Reserve. Although we have had statutory authority for many years to audit the financial transactions of the Federal Deposit Insurance Corporation, our access to examination reports of that agency in connection with such audits has long been a subject of dispute.

In order for us to make this study, it was necessary for us to conduct extensive negotiations with the three agencies for access to the records we require.

On the basis of the agreements reached, we are satisfied that we will be able to obtain the information we need. We are happy to report that thus far we have received good cooperation from the three agencies.

For the first time, we will be able to study the operations of the supervisory agencies with respect to specific banks by reviewing examination reports and related documents.

The agencies' agreements to give us access to this sensitive information are predicated on our assurance to the agencies that we will not disclose the identities of banks or bank customers to anyone outside GAO.

A substantial effort will be involved in performing this study. We expect to study up to 900 banks selected in representative samples.

The samples were taken from three groups of banks.

First, we will look at failed banks to find out what problems they experienced. We will determine what steps were taken by the supervisory agencies to prevent the failures and ask: "What could have been done to save the banks?"

From January 1971 through June 8, 1976, 36 banks failed, and we plan to review the actions of the supervisory agencies with respect to each of these.

Next, we will study a sample of banks which the supervisory agencies have identified as needing special attention. Some of the agencies refer to these as "problem banks."

We plan to review a sample of these banks, determine what problems have been identified by the bank examiners, whether the problems have been brought to the attention of appropriate persons in the banks and in the supervisory agencies and what, if any, actions have been or are being taken to correct them. There are 294 banks in this sample.

Finally, we will look at a general sample of banks selected from the total of over 14,000 banks in operation in the country. We will select 200 banks from each of the three supervisory agencies.

Our study of this sample will help us understand how the examination process is generally carried out and what is done with the information produced.

The samples we selected included banks of all sizes located in urban, suburban, and rural areas. They also include banks having local, regional, national, and international spheres of operation.

Our study of the sampled banks will start with the examination reports prepared by the supervisory agencies. In addition, we will look at related documents, such as correspondence files. In some cases, we will visit agency field offices and interview bank examiners.

Although bank examination is the key part of supervision, we plan to study other aspects as well.

The Comptroller of the Currency issues charters for national banks. We plan to review this activity to determine the criteria used in considering applications and whether the criteria have been applied consistently.

Another area to be covered in our study will be the efforts of the supervisory agencies to develop new systems and procedures to enable them to spot bank problems early.

Our study will include a review of these systems and of other research underway to improve bank supervision.

We are now in the beginning stages of our study. Thus far, we have done the following:

1. Organized a special task force which is giving this project the highest priority.

2. Arranged with the supervisory agencies for access to needed documents.

3. Developed our work plans, selected banks for review, and started the data collection process.

Obviously, we will be gathering a lot of data. To help us analyze it, we will use a structured approach to recording the information we obtain. This will allow us to use computer-assisted quantitative techniques for a large part of our analysis.

With a study as large and complex as this, it is too early for us to say specifically when our work will be completed, but we expect to have a report ready for the early consideration of the new Congress when it convenes next year.

There are now 32 staff members assigned to the task force on a full-time basis. The staff came from several GAO divisions and is made up of a variety of disciplines. They include accountants, economists, financial analysts, and computer specialists. The staff includes persons with actual bank examination experience.

An additional eight staff members, including attorneys, statisticians, system analysts, and economists are assigned on a part-time basis. Also, we have consulted with recognized experts in banking in developing our work plan.

We have just begun to look at the detailed records and now look forward to several months of intensive effort to carry out this assignment.

This concludes my statement, Mr. Chairman.

I have also furnished the subcommittee a summary of our study plan.

If you have any questions on my statement or the study plan, I will be happy to try to answer them.

Mr. ROSENTHAL. Thank you.

Mr. Brown?

Mr. BROWN. Thank you, Mr. Chairman.

Thank you, Mr. Layton, for a good update on where you stand at the present time in connection with your performance audit of the regulatory agencies.

As you know, there has been much discussion about the Haskins and Sells performance audit in connection with it making its recommendations to the Comptroller's Office.

Do you contemplate that your review will be somewhat in the format of Haskins and Sells performance audit? Or is that an unfair question—that you may not be that familiar with what they have done?

Mr. LAYTON. We are familiar with what they've done. I don't think it will duplicate it, but we will be concerned with a lot of the same things.

We will be concerned with the extent that the Comptroller has actually implemented or plans to implement some of the recommendations of the Haskins and Sells report.

Mr. BROWN. In your statement you have indicated that at this point in time you have received full cooperation. Are you satisfied with the cooperation that you have received from the regulatory agencies?

Mr. LAYTON. At this point in time; yes.

Mr. BROWN. I noticed that you indicate in your statement that you will be interviewing bank examiners. Do you contemplate that you will be asking, as you come across things, for documents with respect to specific banks?

Mr. LAYTON. Yes, sir; for all the banks in our sample we will see all of the agencies' records concerning those banks.

Mr. BROWN. And if you come across anything, I would think that the Comptroller would concur that it would be entirely possible and reasonable for you to examine particular transactions, if necessary.

Mr. LAYTON. Maybe I should clarify.

We will not be looking at the records of the banks themselves; only the supervisory agencies.

Mr. BROWN. If you came across something, I think that at that point in time you would probably then negotiate with them as to whether or not specific things should be examined.

Mr. LAYTON. Under the terms of the agreement that we worked out with the agencies, there is nothing that would allow us to go to the banks and deal with that situation.

Mr. BROWN. I know the agreement does not provide it, but I would trust that the regulatory agencies if there is a specific transaction that appears to be wrong, that you would be given the opportunity to have access to it.

Probably most of this you can get through a discussion with the bank examiner so that this matter of having the actual documents would not be necessary.

Mr. LAYTON. Yes; I think so.

We will be basically accepting the examination report in terms of the basic data being valid. Our primary concern will be to determine what the supervisory agencies did with that information once they were aware of a problem.

Mr. BROWN. Bringing your audit up to date, you have people in these different offices now. Are you doing the agencies concurrently or are you doing an agency at a time?

Mr. LAYTON. We have 30 people located at the three agencies; roughly 10 at each agency.

Mr. BROWN. So you will be able to get a chance to correlate the things that you're seeing in one agency vis-a-vis what you're seeing in another agency. Is that correct?

Mr. LAYTON. Yes.

Mr. BROWN. It seems to me that should be very helpful.

I don't have any more questions at this time, Mr. Chairman.

Mr. ROSENTHAL. There has been made available to the members of subcommittee your study plan called: Planned Approach for GAO's Study of Federal Supervision of Banks (Summary).

Do you have any objection to our putting this in the record?

We're going to do it anyhow because it belongs in the public domain.

Mr. LAYTON. Then I won't object.

Mr. ROSENTHAL. There is nothing secret or confidential or a matter of national security? This is just a statement of how you're going to do the job; right?

Mr. LAYTON. Yes.

Our preference would be not to put it in the record, but we have no formal objection.

Mr. BROWN. Would you mind elaborating upon why your preference would be to not have this statement made a part of the record?

Mr. LAYTON. The staff is still in a very early stage. We have a lot of plans here which we hope we can fulfill. Our purpose is not to make a lot of promises until we are sure we can fulfill all of them.

Mr. BROWN. In other words, you don't want, at a future date, to have somebody pull this out and go down it point by point and say: "Where did you do this; why didn't you do that?"

Mr. LAYTON. That's part of it, yes.

Mr. BROWN. I will not object to the introduction of this statement into the record, upon the condition, or the understanding, that this is a very broad, generalized, contemplated synopsis or summary of the audit proposed to be conducted by the General Accounting Office.

But the GAO does not expect to be held to compliance and total fulfillment of all of those things which are set forth in the document entitled: "Planned Approach for GAO's Study of Federal Supervision of Banks (Summary)."

Is that not agreeable with you, Mr. Layton?

Mr. LAYTON. Yes.

Mr. BROWN. I have no objection if the chairman will, in effect, accept the conditions under which I just discussed.

Mr. ROSENTHAL. The conditions are that these are your goals and objectives and you will do the best you can. You may not fulfill them, but this is your plan and outline? Is that correct?

Mr. LAYTON. Yes.

During the course of the next few months when we're working on the study, it may be necessary to establish some priority as to which are the more significant questions.

Some of the others, after we get a little information, we may decide are not that important. We may cut certain things out.

Mr. BROWN. And you may decide to discard it. That's the only condition.

Mr. ROSENTHAL. Without objection, this document will be inserted in the record.

Mr. BROWN. I assume the chairman has accepted the conditions.

Mr. ROSENTHAL. I'm not sure I understand the conditions.

Mr. BROWN. Then just accept them.

Mr. ROSENTHAL. Without objection, the study plan will be inserted in the record.

[The material referred to follows:]

PLANNED APPROACH FOR GAO'S STUDY OF FEDERAL SUPERVISION OF BANKS

(*Summary*)

OBJECTIVE OF THE GAO REVIEW

The objective of the GAO review is to evaluate the effectiveness of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the

Federal Reserve System in carrying out their regulatory and supervisory responsibilities to assure that management weaknesses or financial difficulties in commercial banks are identified and, to the extent possible, resolved.

The major segments of the review, which are described more fully in the following pages are:

1. Survey of overall policies of supervising agencies.
2. Detailed analysis of failed banks.
3. Detailed analysis of banks requiring special attention.
4. Review of scope and results of bank examinations (Broad Sample).
5. Review of applications for charters and conversion of charters.
6. Survey of efforts to anticipate and respond to potential problems in bank operations.
7. Survey of personnel and training practices.

SURVEY OF OVERALL POLICIES OF SUPERVISING AGENCIES

Purpose

1. To identify and compare the bank supervision and regulation policies and procedures established by the OCC, FDIC, and FRS.

2. Identify the extent to which policies and procedures vary from region to region (Federal Reserve Bank to Federal Reserve Bank) and from headquarters to region within each agency.

3. To identify and document any recent efforts by each of the agencies to improve the policies, procedures, and practices (such as the Haskins and Sells study of OCC) and the applicability of improvements made by one agency to the policies, procedures and practices followed by the others.

Approach/scope

Within the boundaries established in the memoranda of agreement between GAO and the three agencies, we will review each agency's written policies and procedures, with regard to:

The scheduling, conducting, and reporting of regular and special bank examinations (commercial, trust, EDP, and foreign operations);

The assignment of ratings to banks (including the criteria used to determine bank soundness);

The changing of a bank's rating from "problem" to "non-problem" or from "non-problem" to "problem";

The monitoring of banks to ensure the correction of problems disclosed by examinations;

Each agency's use of remedial powers (such as moral suasion, cease and desist orders, suspension and removal);

The recruitment, training, and advancement opportunities of bank examiners;

The conducting of operations reviews to evaluate the quality of bank examinations;

The coordination and cooperation with State banking authorities, other Federal agencies (Justice, EEOC), and each other on matters relative to bank supervision and regulation;

The use of research and analysis to develop new or improved supervisory and regulatory approaches.

Each agency's use of internal audit and evaluation staffs to improve supervisory and regulatory approaches (includes size of internal audit staffs, reporting relationships, type and scope of audits performed).

The extent to which actual practices conform to established policies and procedures will be determined in other phases of our review.

DETAILED ANALYSIS OF FAILED BANKS

Purpose

To determine the effectiveness of bank supervision conducted by the three agencies, we will study the roles each played in trying to prevent bank failures which occurred in the past 5 years. We will ascertain:

Why the banks failed,

What the supervisory agencies did to try to prevent the failures, and

Why the actions did not work.

As used here, a failed bank is one that ceased operations as an entity by outright liquidation and payout to insured depositors or by the assumption of its business (by merger or purchase) by another entity. (FDIC definition).

Approach/scope

Our analysis will cover the 36 banks that have failed since January 1, 1971. In studying these banks, we will review the reports of examinations made by the respective supervisory agencies, related correspondence, and reports of condition filed by the banks. We plan to obtain the documents for the year in which a bank failed and for the preceding 4 years, giving a total of 5 years of history for each failed bank.

To the extent needed, we will supplement the written information with interviews with examiners and other personnel of the supervisory agencies.

In addition to the questions mentioned above, we will try to obtain answers to the following:

1. Did the regulatory agenicies identify problems or indications of problems before they failed? How early were they detected?

2. What actions did the regulatory agencies take to try to correct the identified problems?

(*a*) Were they appropriate?

(*b*) Why didn't they work?

3. Under the current legislative authority, was there anything the agencies could have done that they did not do to try to prevent the failures?

4. Would broadening the agencies powers—giving them more available alternatives—have helped the situation?

5. How much was actually lost by depositors?

DETAILED ANALYSIS OF BANKS REQUIRING SPECIAL ATTENTION

Purpose

1. To determine whether the examination procedures adequately provide for early detection of problems, and disclosure to the appropriate parties.

2. To determine the effectiveness of the supervisory agencies' actions intended to resolve problems so that the banks no longer require special attention.

Approach/scope

At each of the regulatory agencies, we will obtain a listing of banks requiring special attention as of January 1, 1971, and December 31, 1975. From each agency's listing, we will select a sample for detail review for both points in time. A total of 294 banks will be included in the sample.

For the sample of banks as of December 31, 1975, we will identify the problems, and review the agencies' actions to resolve the problems from the time the bank was put on the problem list. We will also review the examination report which immediately preceded the examination report that resulted in designating the bank as requiring special attention.

For the sample of problem banks as of January 1, 1971, we will identify the problems, and review the agencies action to resolve the problems up to the present time (or until the bank was taken off the list).

By comparing data collected for all banks, we will be able to make comparative analyses of "problem" banks with "non-problem" banks.

We will also determine:

Changes to the number of banks designated as requiring speical attention during the 5-year period.

Length of time banks continue to be designated.

Causes of the banks' problems.

Whether the examination procedures provide for early detection of problems.

How effective the agencies are in getting problems corrected.

Agencies methods for monitoring or follow-up on problems banks including use of available remedial powers. (The two samples will enable us to see any major changes in the agencies' approaches.)

REVIEW OF SCOPE AND RESULTS OF BANK EXAMINATIONS (BROAD SAMPLE)

Purpose

To ascertain whether:

1. The scope and procedures of bank examinations are adequate to determine the condition, and quality of management of the bank as well as the banks' compliance with applicable laws and regulations.

2. The conclusions of the examiners adequately reflect the results of the examinations.

3. The regulatory agencies, through the examination process, contribute to the prevention or correction of situations that might adversely affect the soundness of the bank or the general public interest.

Approach/scope

We will review the three most recent examination reports of a sample of 200 banks supervised by each of the three agencies.

Key data will be extracted from each of the reports and related correspondence files for the banks in the sample. The type of data to be collected will include the examiners findings and conclusions, data which supports the examiners findings and conclusions, data that indicates the condition of the bank or the existence of a possible problem, data on various laws and regulations affecting banks, and corrective actions proposed by the regulatory agencies and the actions taken by the bank.

In those cases where review of the examination reports show conflicting information in the reports or possible weaknesses in the examination process, we will also review the supporting working papers, discuss the reports with examiners who performed the work, and discuss the cases with regional and headquarters officials.

We also plan to review the procedures for making examinations of international branches, trust, EDP, national credits, and country credits. We will also determine that the prescribed procedures were actually applied in the sample banks reviewed.

REVIEW OF APPLICATIONS FOR CHARTERS AND CONVERSION OF CHARTERS

Purpose

1. To determine the criteria used to evaluate applications.
2. To compare the Comptroller's criteria to that used by State regulatory authorities.
3. To determine if the criteria is applied consistently by the Comptroller.
4. To determine if improper decisions contribute to bank failures or problem bank situations.

Approach/scope

We will analyze a sample of new charter and conversion applications the Comptroller has considered (both approved or disapproved) since January 1, 1974. The Comptroller receives approximately 200 charter and 12 conversion applications a year. More than half of the charter applications and nearly all conversion applications are approved. We will inquire into:

The reasonableness of the time used by the Comptroller to process applications.

The extent that disapproved State charter applications are subsequently approved by the Comptroller.

The reason banks convert charters, including whether banks convert from State to national charters (or the reverse) to escape regulatory action by Federal or State authorities.

The effect of charter decisions on bank failures and problem banks.

SURVEY OF EFFORTS TO ANTICIPATE AND RESPOND TO POTENTIAL PROBLEMS IN BANK OPERATIONS

Purpose

1. To evaluate research and analysis efforts designed, in the short-run, to identify banks which may become problems, and in the long-run, to anticipate and respond to significant developments affecting the banking industry.
2. To determine what research is being done to evaluate the reliability problem conditions.
3. To determine how the agencies recognize and accommodate the risk-taking nature of the banking industry when developing their tests of bank soundness.

Approach/scope

In each agency, the focus will be on elements responsible for research, analysis, planning, strategic studies, and related areas.

This study will show whether the supervisory agencies are anticipating and identifying short- and long-range problems that may impact on bank operations. The study will describe and evaluate whether the response (i.e., regulations, changes in examinations) to identified problems was appropriate and timely.

SURVEY OF PERSONNEL AND TRAINING PRACTICES

Purpose

To assess the extent that the agencies personnel and training practices contribute to high quality bank examiners. We will also explore the degree of independence and professionalism of the staff.

Approach/scope

The survey will focus on the following areas in each agency:

Recruiting policies and standards.
Relevance and quality of training programs.
Criteria for commissioning examiners.
Impact of rotation and turnover on examiner independence.
Regulations to identify and safeguard against conflicts of interest.

Mr. ROSENTHAL. Has there been varying degrees of cooperation from the bank agencies? In other words, has the Federal Reserve been more forthcoming than the Comptroller of the Currency or have they been all generally forthcoming or have there been any variations you would want to tell us about?

Mr. LAYTON. There were differences in dealing with the agencies at the time that we were negotiating our basic agreement on access to records. I would not say that any one was any less cooperative than another.

In the case of the Federal Reserve, there were some different issues; because their responsibilities are different. In addition to bank supervision, they have other responsibilities. They were concerned that we clarify specifically what would be within the scope of this study and what would not.

Mr. ROSENTHAL. Did you enter into an agreement with the various agencies, a signed agreement?

Mr. LAYTON. Yes.

Mr. ROSENTHAL. Do you have a copy of that?

Mr. LAYTON. Yes.

Mr. ROSENTHAL. Do you have any objection to our putting that in the record?

Mr. LAYTON. No. There are three separate agreements.

Mr. ROSENTHAL. Do you have any objection, Mr. Brown?

Mr. BROWN. No.

Mr. ROSENTHAL. Without objection, those three agreements will be inserted in the record at this point.

[The material referred to follows:]

MEMORANDUM OF AGREEMENT BETWEEN THE COMPTROLLER OF THE CURRENCY AND THE COMPTROLLER GENERAL OF THE UNITED STATES

I. PURPOSE

On January 24, 1976, the Chairman, Subcommittee on Domestic Monetary Policy of the Committee on Banking, Currency and Housing, United States House of Representatives, requested the Comptroller General of the United States, through the General Accounting Office (GAO), to conduct a review and evaluation of the supervisory responsibilities relating to banks under the jurisdiction of the Comptroller of the Currency. This request was reiterated by letter of February 5, 1976, from the Committee to the Comptroller of the Currency.

The Chairman, Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations, United States House of Representatives made a similar request to the Comptroller General on April 16, 1976, pursuant to the full Committee's motion on March 25, 1976.

The Comptroller of the Currency has consented to such a review, evaluation, and report by GAO to: (a) assist the House Committee on Banking, Currency and Housing, the House Government Operations Committee, and other appropriate congressional committees in exercising their legislative oversight responsibilities; (b) inform the public about the operations of the Office of the Comptroller of Currency (OCC); and (c) give the Comptroller of the Currency an independent opinion on the effectiveness of his office in discharging a major portion of its statutory responsibilities.

II. OPERATIVE PROVISIONS

The Comptroller General, on behalf of the General Accounting Office, and the Comptroller of the Currency, on behalf of the Office of the Comptroller of the Currency, therefore agree to the following:

(1) Scope of Review and Evaluation

(a) GAO will undertake a review of the OCC to evaluate the effectiveness of the Comptroller in discharging his bank supervision and regulatory responsibilities. This review will include, but not be limited to, the procedures used by national bank examiners in their periodic on-site examinations of national banks, the manner in which the findings and conclusions of bank examiners are reported, the manner in which financial data is collected from national banks and used by the OCC, the systems employed by the OCC to identify and attempt to achieve correction of problems occurring at particular national banks, the recruiting and training of bank examiners, and the methods by which the OCC reviews its own performance and plans for its future needs.

(b) The GAO review will include, but not be limited to, the following types of bank examination performed by OCC: domestic, international, electronic data processing, trust, national credit, and country credit.

(c) In conducting the review described in subparagraphs (a) and (b), GAO will consider OCC practices, procedures, and policies as they existed both before and after implementation of the changes resulting from the recent management study of OCC by the private accounting and consulting firm of Haskins & Sells. Consideration will be given to all new workpaper forms, manuals, and other written instructions relating to each type of examination.

(2) Access to Records

OCC will afford authorized GAO personnel access to, and permission to examine, all of its records, books, and documents and other material relating to the bank supervisory and regulatory functions of OCC. Included in such documents are bank examination reports, together with workpapers and correspondence files related to such reports, whether or not a part of the report, and all without any deletions. The GAO review will be conducted in such a manner as to cause a minimum of disruption in the normal operations of the Comptroller of the Currency. Mutually agreeable arrangements will be made with respect to availability of OCC records in current, active use and to interviews of agency officials. Authorized GAO personnel will be permitted to make whatever notes or whatever copies they deem necessary during the review, all to be contained in the GAO workpapers. These workpapers will be safeguarded in accordance with paragraph (6) of this Agreement.

(3) Authorized GAO Personnel

(a) The Comptroller General will have sole authority for assigning the GAO personnel to be engaged in the review.

(b) GAO will provide OCC with a list of its personnel authorized to have access to OCC records in connection with this review and evaluation at the time this agreement is executed, with the list updated as changes occur. Assigned GAO personnel will carry official GAO credentials that will be presented to OCC personnel on request.

(c) To the extent possible, GAO will use auditors with experience in reviewing reports of depositary institutions.

(4) OCC Liaison Official; Facilities

(a) OCC will designate a liaison official to facilitate the GAO access to OCC records and personnel for the purpose of this review.

(b) OCC will provide GAO with suitable, lockable office space and furniture, telephone and access to copying facilities. These working facilities will be adequate for up to ten GAO auditors, the exact number to be determined later.

(5) *Procedures*

(a) This review and evaluation will be conducted in accordance with audit procedures and standards prescribed by the Comptroller General, subject to the terms of this agreement.

(b) The selection of examination reports for GAO review will be made on a sampling basis determined by the GAO to be adequate for the purposes of the review, after consultation with OCC. Depending on the purpose of the audit tests, it may be necessary to select more than one sample.

(c) In making its review, the GAO will interview OCC personnel, including, but not limited to, national bank examiners and regional administrators, in order to obtain an adequate understanding of all phases of OCC's bank supervision and regulatory responsibilities. GAO will not evaluate the accuracy of the examiner's factual findings by conducting separate examinations of the banks involved. GAO personnel may accompany national bank examiners during examinations of one or more banks to be selected jointly by OCC and GAO, provided that the bank being examined consents to the presence of GAO personnel during the examination.

(d) The GAO will prepare a report to the Congress with its conclusions as to the matters specified in paragraph (1) An advance draft of the GAO report will be made available to OCC, which will be afforded an adequate opportunity to comment on the contents of the proposed report. The final report will include as an addendum any written comments submitted by the Comptroller of the Currency.

(6) *Safeguarding the Identity of Banks and Customers*

In making its review, GAO will safeguard the identity of banks and bank customers as follows:

(a) All GAO workpapers, and whatever OCC documents or records come into GAO possession during the review will remain on the premises of OCC. Such material will be maintained in such a way as to prevent unauthorized access. When not in use, such material will be kept in secure, locked file cabinets.

(b) GAO, in its report and otherwise outside of GAO, will not (i) identify bank customers; (ii) identify any bank; or (iii) provide detail that can lead to identification of any bank or bank customer. Within these limitations, GAO, in its report and otherwise outside of GAO, may discuss the condition or operations of a particular bank.

(c) The limitations of this paragraph shall not prohibit GAO or its employees from discussing particular banks or bank customers: (i) with officials of the Federal Reserve System or of the Federal Deposit Insurance Corporation if those agencies were involved in transactions or supervisory procedures related to such bank or bank customers; or (ii) with officials of OCC.

(d) Upon completion of the review and issuance of the report, all GAO files and workpapers will be retained for a period of ten years. They will be kept on the premises of OCC for one year from the date of issuance of the report, provided, however, that authorized GAO auditors shall have the continued right of access to such material during that time period. After one year from the date of issuance of the GAO report, OCC may send the GAO files and workpapers to the Federal Records Center for storage for an additional nine years, provided, however, that OCC will recall such files and workpapers from storage at GAO request so that GAO personnel may have access to them on the premises of OCC. On or after ten years from the date of issuance of the GAO report, OCC may direct destruction of the files and workpapers unless notified to the contrary by GAO.

(7) *Field Activities*

To the extent the conduct of the review will be outside of the Washington, D.C. area, mutually agreeable procedures, consonant with the Agreement, will be developed concerning access to and security of records.

April 21, 1976.

ELMER B. STAATS,
Comptroller General of the United States.
JAMES E. SMITH,
Comptroller of the Currency.

Memorandum of Agreement Between Board of Governors of the Federal Reserve System and the Comptroller General of the United States

I. Purpose

On January 24, 1976, the Chairman, Subcommittee on Domestic Monetary Policy of the Committee on Banking, Currency and Housing, United States House of Representatives, requested the Comptroller General of the United States, through the General Accounting Office (GAO), to study and evaluate the supervisory responsibilities relating to banks under the jurisdiction of the Federal Reserve System. This request was reiterated by letter of February 5, 1976, from the Committee to the Chairman, Board of Governors of the Federal Reserve System.

The Board of Governors has consented to such a study, evaluation, and report so that GAO may assess the effectiveness of the Board in discharging its bank supervisory responsibilities. For the purpose of this Agreement, the term "bank supervisory responsibilities" shall mean those functions of the FRS involving the examination of State member banks and the detection of unsafe or unsound, or potentially unsafe or unsound conditions in such banks, or violations of law or regulation by such banks, and the process by which the FRS seeks to remedy such conditions or violations and otherwise protect the solvency and soundness of State member banks.

II. Operative Provisions

The Comptroller General, on behalf of the General Accounting Office, and the Board of Governors, on behalf of the Federal Reserve System (FRS), therefore agree to the following:

(1) Scope of Study and Evaluation

(a) GAO will study the effectiveness of the Board of Governors in discharging its bank supervision responsibilities during the past five years. This study will include the procedures used by FRS bank examiners in their periodic on-site examinations of State member banks, the manner in which the findings and conclusions of bank examiners are reported, the manner in which financial data is collected from State member banks by the FRS for bank supervisory purposes, the systems employed by the FRS to identify and attempt to achieve correction of problems occurring at particular State member banks, the recruiting and training of bank examiners, the methods by which the FRS reviews its own bank supervisory performance and plans for its future needs in that area, and other subjects directly and clearly related to the bank supervisory process.

The GAO study will be conducted principally through the selection of one or more statistical samples of State member banks for detailed study. To the extent necessary to evaluate the manner in which the FRS has dealt with unsafe or unsound conditions, or potentially unsafe or unsound conditions, or violations of law or regulations, detected in the bank supervisory process with respect to any bank selected for study in any such sample, GAO may inquire into the manner in which the FRS has dealt with applications from a parent bank holding company of such bank, or applications from the bank for the establishment of branches or for membership in the Federal Reserve System.

(b) The GAO study will include the following types of bank examination performed by FRS: commercial, foreign operations, electronic data processing and trust.

(c) Except insofar as regulatory actions of the FRS are directly related to banks selected for study in a sample, as provided in subsection (a) above, the GAO study shall not include an evaluation of the performance by FRS of its regulatory functions generally, such as its policies and procedures for implementing the Bank Holding Company Act, the Bank Merger Act, consumer protection statutes, the securities laws, or laws or regulations relating to bank reserves, payment of interest on deposits, or securities credit. In no event shall the study be deemed to include in any respect the monetary policy functions of the FRS or the operations of the FRS relating to the payments mechanism, such as check clearing or electronic funds transfer, or to the handling of currency or securities.

(2) Access to Records

FRS will afford authorized GAO personnel access to, and permission to examine, all FRS records, books, and documents and other material relating to the bank supervisory functions of FRS.

FRS examination reports of State member banks will be included in such documents to the extent such banks are selected for study in the sample(s) referred to in paragraph (5)(b), together with work papers and correspondence files related to such reports, whether or not a part of the report, and all without any deletions.

The GAO study will be conducted in such a manner as to cause a minimum of disruption in the normal operations of the Board of Governors and the Federal Reserve Banks. Recognizing that FRS may in certain cases require priority use of its records, mutually agreeable arrangements will be made with respect to availability of those records in current, active use. Similar arrangements will be made regarding the availability of agency officials for interviews.

Authorized GAO personnel will be permitted to make whatever notes or whatever copies they deem necessary during the study, all to be contained in the GAO workpapers. These workpapers will be safeguarded in accordance with paragraph (6) of this Agreement.

(3) Authorized GAO Personnel

(a) The Comptroller General will have sole authority for assigning the GAO personnel to be engaged in the study.

(b) GAO will provide FRS with a list of its personnel authorized to have access to FRS records in connection with this study and evaluation at the time this agreement is executed, with the list updated as changes occur. Assigned GAO personnel will obtain necessary credentials for entering FRS facilities and will carry official GAO credentials that will be presented to FRS personnel on request.

(c) To the extent possible, GAO will use personnel with experience in reviewing reports of depositary institutions.

(4) FRS Liaison Official; Facilities

(a) FRS will designate a liaison official to facilitate the GAO access to FRS records and personnel for the purpose of this study. GAO will clear all requests for documents and interviews through the liaison official.

(b) FRS will provide GAO with suitable, lockable office space and furniture, telephone and access to copying facilities. These working facilities will be adequate for up to ten GAO representatives, the exact number to be determined later.

(5) Procedures

(a) This study and evaluation will be conducted in accordance with procedures and standards prescribed by the Comptroller General, subject to the terms of this Agreement.

(b) The selection of examination reports for GAO study will be made on a statistical sampling basis determined by the GAO to be adequate for the purposes of the study, after consultation with the Board of Governors. Depending on the purpose of the study, it may be necessary to select more than one sample.

(c) In making its study, the GAO will interview FRS personnel, including bank examiners and Federal Reserve Bank Officers and staff, in order to obtain an adequate understanding of all phases of FRS' bank supervisory responsibilities. GAO will not evaluate the accuracy of the examiner's factual findings or make separate examinations of the banks involved.

(d) The GAO will prepare a report to the Congress with its conclusions as to the matters specified in paragraph (1). An advance draft of the GAO report will be made available to the Board of Governors, who will be afforded an adequate opportunity to comment on the contents of the proposed report. The final report will include as an addendum any written comments submitted by the Board of Governors.

(6) Safeguarding the Identity of Banks and Customers

In making its study, strict confidentiality shall be maintained by GAO and all GAO personnel participating in the study. GAO will safeguard the identity of banks, bank officials and bank customers as follows:

(a) All GAO workpapers, and whatever FRS documents or records come into GAO possession during the study will remain on the premises of FRS. Such material will be maintained in such a way as to prevent unauthorized access. When not in use, such material will be kept in secure, locked file cabinets.

(b) GAO, in its report and otherwise outside of GAO, will not (i) identify bank customers; (ii) identify any bank or bank officers, directors or stockholders; or (iii) provide detail that can lead to identification of any bank, bank customer, bank officer, director or stockholder. Within these limitations, GAO, in its report and otherwise outside of GAO, may discuss the condition or operations of a particular bank.

GAO shall make no disclosure whatsoever outside of GAO or the Federal Reserve of the identity of any bank selected as a sample bank for purposes of the study, whether to the bank being studied or otherwise.

(c) The limitations of this paragraph shall not prohibit GAO or its employees from discussing particular banks, bank officials or bank customers: (i) with officials of the Office of the Comptroller of the Currency or of the Federal Deposit Insurance Corporation if those agencies were involved in transactions or supervisory procedures related to such bank or bank customers; or (ii) with officials of FRS.

(d) The non-disclosure provision of this paragraph shall apply with respect to any affiliate of a bank covered by the study.

(e) Upon completion of the study and issuance of the report, all GAO files and workpapers will be retained for a period of ten years. They will be kept on the premises of the Board of Governors for one year from the date of issuance of the report, provided, however, that authorized GAO personnel shall have the continued right of access to such material during that time period. After one year from the date of issuance of the GAO report, FRS may send the GAO files and workpapers to the Federal Records Center for storage for an additional nine years, provided, however, that FRS will recall such files and workpapers from storage at GAO request so that GAO personnel may have access to them on the premises of FRS. On or after ten years from the date of issuance of the GAO report, FRS may direct destruction of the files and workpapers unless notified to the contrary by GAO.

(7) *Field Activities*

To the extent the conduct of the study will be outside of the Washington, D.C. area, mutually agreeable procedures, consonant with the Agreement, will be developed concerning access to and security of records.

ARTHUR F. BURNS,
Chairman, Board of Governors, Federal Reserve System.
ELMER B. STAATS,
Comptroller General of the United States.

MEMORANDUM OF AGREEMENT BETWEEN FEDERAL DEPOSIT INSURANCE CORPORATION AND THE COMPTROLLER GENERAL OF THE UNITED STATES

I. PURPOSE

On January 24, 1976, the Chairman, Subcommittee on Domestic Monetary Policy of the Committee on Banking, Currency and Housing, United States House of Representatives, requested the Comptroller General of the United States, through the General Accounting Office (GAO), to conduct a review and evaluation of the supervisory responsibilities relating to banks under the jurisdiction of the Federal Deposit Insurance Corporation (FDIC). This request was reiterated by letter of February 5, 1976, from the Committee of the Chairman, FDIC. The Chairman has consented to such a review, evaluation, and report by GAO.

II. OPERATIVE PROVISIONS

The Comptroller General, on behalf of the General Accounting Office, and the Chairman, on behalf of FDIC, therefore agree to the following:

(1) *Scope of Review and Evaluation*

(a) GAO will undertake a review of FDIC to evaluate FDIC's effectiveness in discharging its bank supervision and regulatory responsibilities. This review will include, but not be limited to, the procedures used by FDIC bank examiners in their periodic on-site examinations of insured nonmember State banks, the manner in which the findings and conclusions of bank examiners are reported, the manner in which financial data is collected from the banks and used by FDIC, the systems employed by FDIC to identify and attempt to achieve correction of problems occurring at particular banks, the recruiting and training of bank examiners, and the methods by which FDIC reviews its own performance and plans for its future needs.

(b) The GAO review will include, but not be limited to, the following types of bank examinations performed by FDIC: commercial, compliance, trust, mutual savings banks, and electronic data processing control evaluations.

(c) In conducting the review described in subparagraphs (a) and (b), GAO will consider, as appropriate in the judgment of the Comptroller General, practices, procedures, and policies in existence prior to and at the time of this review.

(2) *Access to Records*

FDIC will afford authorized GAO personnel access to, and permission to examine, all of its records, books, and documents and other material relating to the bank supervisory and regulatory functions of FDIC. Included in such documents are bank examination reports, together with workpapers and correspondence files related to such reports, whether or not a part of the report, and all without any deletions. The GAO review will be conducted in such a manner as to cause a minimum of disruption in the normal operations of the FDIC.

Mutually agreeable arrangements will be made with respect to availability of FDIC records in current, active use and to interviews of agency officials.

Authorized GAO personnel will be permitted to make whatever notes or whatever copies they deem necessary during the review, all to be contained in the GAO workpapers. These workpapers will be safeguarded in accordance with paragraph (6) of this Agreement.

(3) *Authorized GAO Personnel*

(a) The Comptroller General will have sole authority for assigning the GAO personnel to be engaged in the review.

(b) GAO will provide FDIC with a list of its personnel authorized to have access to FDIC records in connection with this review and evaluation at the time this agreement is executed, with the list updated as changes occur. Assigned GAO personnel will carry official GAO credentials that will be presented to FDIC personnel on request.

(c) To the extent possible, GAO will use auditors with experience in reviewing reports of depository institutions.

(4) *FDIC Liaison Official; Facilities*

(a) FDIC will designate a liaison official to facilitate the GAO access to FDIC records and personnel for the purpose of this review.

(b) FDIC will provide GAO with suitable, lockable office space and furniture, telephone and access to copying facilities. These working facilities will be adequate for up to ten GAO auditors, the exact number to be determined later.

(5) *Procedures*

(a) This review and evaluation will be conducted in accordance with audit procedures and standards prescribed by the Comptroller General, subject to the terms of this agreement.

(b) The selection of examination reports for GAO review will be made on a sampling basis determined by the GAO to be adequate for the purposes of the review, after consultation with FDIC. Depending on the purpose of the audit tests, it may be necessary to select more than one sample.

(c) In making its review, the GAO will interview FDIC personnel, including, but not limited to, bank examiners and regional directors, in order to obtain an adequate understanding of all phases of FDIC bank supervision and regulatory responsibilities. GAO will not evaluate the accuracy of the examiner's factual findings by conducting separate examinations of the banks involved.

(d) The GAO will prepare a report to the Congress with its conclusions as to the matters specified in paragraph (1). An advance draft of the GAO report will be made available to FDIC, which will be afforded an adequate opportunity to comment on the contents of the proposed report. The final report will include as an addendum any written comments submitted by the Chairman, FDIC.

(6) *Safeguarding the Identity of Banks and Customers*

In making its review, GAO will safeguard the identity of banks and bank customers as follows:

(a) All GAO workpapers, and whatever FDIC documents or records come into GAO possession during the review will remain on the premises of FDIC. Such material will be maintained in such a way as to prevent unauthorized access. When not in use, such material will be kept in secure, locked file cabinets.

(b) GAO, in its report and otherwise outside of GAO, will not (i) identify bank customers; (ii) identify any bank; or (iii) provide detail that can lead to identification of any bank or bank customer. Within these limitations, GAO, in its report and otherwise outside of GAO, may discuss the condition or operations of a particular bank.

(c) The limitations of this paragraph shall not prohibit GAO or its employees from discussing particular banks or bank customers: (i) with officials of the Federal Reserve System or of the Comptroller of the Currency if those agencies were involved in transactions or supervisory procedures related to such bank or bank customers; or (ii) with officials of FDIC.

(d) Upon completion of the review and issuance of the report, all GAO files and workpapers will be retained for a period of ten years. They will be kept on the premises of FDIC for one year from the date of issuance of the report, provided, however, that authorized GAO auditors shall have the continued right of access to such material during that time period. After one year from the date of issuance of the GAO report, FDIC may send the GAO files and workpapers to the Federal Records Center for storage for an additional nine years, provided, however, that FDIC will recall such files and workpapers from storage at GAO request so that GAO personnel may have access to them on the premises of FDIC. On or after ten years from the date of issuance of the GAO report, FDIC may direct destruction of the files and workpapers unless notified to the contrary by GAO.

(7) *Field Activities*

To the extent the conduct of the review will be outside of the Washington, D.C., area, mutually agreeable procedures, consonant with the Agreement, will be developed concerning access to and security of records.

ELMER B. STAATS,
Comptroller General of the United States.
ROBERT E. BARNETT,
Chairman, Federal Deposit Insurance Corporation.

Mr. ROSENTHAL. I am interested in knowing if those agreements provide for continuing oversight by the GAO or is this a one-shot investigation?

Mr. LAYTON. No; it's a one-shot investigation.

Mr. ROSENTHAL. Is there a time frame of when it's to be concluded?

Mr. LAYTON. No; there is no specific date in there for concluding the study.

Mr. ROSENTHAL. That is a policy question.

I thought this was an open-ended authorization.

Mr. LAYTON. I think the attitude of the agencies would probably be that if we're to have continuing access that the best way to get that would be to have a law passed giving us access.

Mr. ROSENTHAL. Yes.

How long do you anticipate before you can conclude your work and make a report to the Congress?

Mr. LAYTON. Our target is to have a report to the Congress in December or early January.

Mr. ROSENTHAL. Of this year?

Mr. LAYTON. Yes.

We are still very early in the study. We may not be able to meet it. We're doing everything we can to meet it. If it goes over a couple of months——

Mr. ROSENTHAL. I understand there are some changes being made, for example, at the Office of the Comptroller of the Currency pursuant to the Haskins & Sells recommendations. I assume you will be examining their new or proposed method of operation, rather than something they're on the verge of discarding?

Mr. LAYTON. Yes; we'll be doing both.

With regard to specific banks, we will draw a sample from the historical data. We will have to be looking at what has already happened.

We will also be looking at the changes they are making. In many cases, the changes are in just the beginning stages; therefore, it's not going to be possible to look at actual cases.

For example, they are coming out with a new examination procedure, I think it's probably been applied at maybe one or two banks. It will really be too early to arrive at any conclusion on how much more effective that is than the old procedures.

Mr. ROSENTHAL. Could you tell us a little about your 32 people—their competency, background, experience? I would assume everybody is competent and qualified, but could you elaborate on that at all?

Mr. PULLEN. We have 32 staff members: 18 are accountants, of which 6 are CPAs; 2 have advanced degrees in economics; 1 is experienced in international economics; 1 is a financial analyst; 10 are management analysts; and 3 have had previous experience as bank examiners.

Mr. ROSENTHAL. How many?

Mr. PULLEN. Three.

Mr. ROSENTHAL. This is a qualified, competent group to do this very important assignment?

Mr. LAYTON. Yes.

Mr. ROSENTHAL. Do you have any estimate of the cost of this?

Mr. LAYTON. Our estimate at this point, and this is based on our plans of having the job finished in December, if all goes well, we estimate the cost at roughly $500,000.

Mr. ROSENTHAL. Mr. Brown?

Mr. BROWN. Will you be reluctant to comment upon the implementation by the Comptroller of the Haskins & Sells recommendations?

There are certain recommendations, I am sure, Haskins & Sells have made that the Comptroller may have a differing view on. I am just giving you an example.

It seems to me that you are in a good position to tell us as to whether or not you think the Comptroller is right or Haskins & Sells is right with respect to how that matter needs to be resolved.

Will you feel free to do so? Right?

Mr. LAYTON. Yes; we will feel free to do so.

Mr. BROWN. As I recall, neither the request of the Committee on Banking, Currency and Housing, and the full committee and subcommittee chairmen, nor the resolution adopted by this full committee call for continuing oversight.

As I recall, they both called for a performance audit.

Mr. LAYTON. For a specific study, yes.

Mr. BROWN. Whether or not there should be continuing oversight, it seems to me, Mr. Chairman, remains within the prerogative of this committee and the Committee on Banking, Currency and Housing.

It seems to me that the decision on the concept of continuing oversight should be delayed pending the outcome of this performance report.

Mr. Layton. The Comptroller General in testimony before several committees has made his views known on that, and it is that we should have continuing oversight; but that it should be provided for by law.

Mr. Brown. I have nothing further.

Mr. Rosenthal. So far it looks reasonably good, and I hope you will pursue it with vigor.

Mr. Layton. Thank you.

Mr. Rosenthal. I do hope that you will have this report available to us by this year.

The subcommittee stands adjourned.

[Whereupon, at 11 a.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

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